BEFORE THE OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

IN THE MATTER OF THE APPEAL OF,	)	
	)	
PACIFIC BELL TELEPHONE COMPANY, BELLSOUTH CORPORATION & AFFILIATES,	)	OTA NO. 21047581, 21047582
	)	
APPELLANT.	)	
	)	
	)	

TRANSCRIPT OF PROCEEDINGS

Sacramento, California

Tuesday, September 11, 2026

Reported by:
ERNALYN M. ALONZO
HEARING REPORTER

BEFORE THE OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

IN THE MATTER OF THE APPEAL OF,	)	
	)	
PACIFIC BELL TELEPHONE COMPANY,	)	OTA NO. 21047581,
BELLSOUTH CORPORATION & AFFILIATES,	)	21047582
	)	
APPELLANT.	)	
	)	
	)	

Transcript of Proceedings, taken at 400 R Street, Sacramento, California, 95811, commencing at 9:05 a.m. and concluding at 1:35 p.m. on Tuesday, September 11, 2026, reported by Ernalyn M. Alonzo, Hearing Reporter, in and for the State of California.

APPEARANCES:

Panel Lead:	ALJ SARA A. HOSEY
Panel Members:	ALJ JOSH LAMBERT ALJ KENNETH GAST
For the Appellant:	JEFFREY M. VESELY ANNIE H. HUANG
For the Respondent:	STATE OF CALIFORNIA FRANCHISE TAX BOARD LAURIE MCELHATTON DELINDA TAMAGNI JASON RILEY LEO CRISTOBAL

I N D E X

REBUTTAL FOR ISSUE NO. 2

	PAGE
By Mr. Vesely	5, 41
By Ms. Tamagni	37

PRESENTATION FOR ISSUE NO. 3

	PAGE
By Ms. Huang	43
By Ms. McElhatton	47

REBUTTAL FOR ISSUE NO. 3

	PAGE
By Ms. Huang	68
By Ms. McElhatton	74

PRESENTATION FOR ISSUE NO. 4

	PAGE
By Mr. Vesely	76
By Mr. Riley	81

REBUTTAL FOR ISSUE NO. 4

	PAGE
By Ms. Huang	88 91
By Ms. McElhatton	89

I N D E X

PRESENTATION FOR ISSUE NO. 5

	PAGE
By Mr. Vesely	93
By Ms. McElhatton	96

REBUTTAL FOR ISSUE NO. 5

	PAGE
By Mr. Vesely	104

PRESENTATION ON ISSUE NO. 6

	PAGE
By Ms. Vesely	106
By Ms. McElhatton	108

REBUTTAL FOR ISSUE NO. 6

	PAGE
By Mr. Vesely	119
By Mr. McElhatton	120

PRESENTATION FOR ISSUE NO. 7

	PAGE
By Mr. Vesely	122
By Mr. Cristobal	127

I N D E X

REBUTTAL FOR ISSUE NO. 7

	PAGE
By Mr. Vesely	134

CLOSING STATEMENT

	PAGE
By Ms. Huang	139
	174
By Ms. McElhatton	163

Sacramento, California; Tuesday, September 11, 2026

9:05 a.m.

JUDGE HOSEY: We are now back on the record in the Appeal of Pacific Bell Telephone Company. It's September 11, 2026, and it's 9:05 a.m.

We are moving up to Appellants for oral arguments on rebuttal for Issue No. 2.

You can begin when ready. Thank you.

MR. VESELY: Thank you, Your Honor.

REBUTTAL ON ISSUE NO. 2

MR. VESELY: Your Honor, I think -- and Judge Gast, Judge Lambert, one of the things that I think we have to keep in mind is really, what is the standard for what is to determine whether the dividends from stock should be considered business or non-business income. We spent a lot of time on that yesterday. And the Hoechst Celanese case has got -- got the standard that we talked about a lot. And I think that needs be kept in mind as we go through what the FTB argued yesterday.

As we know the whole issue is the focus on the stock that AT&T held in Telmex, Telmex Internacional, and America Móvil, and the question whether it was integrally related to AT&T's unitary business operations. That

doesn't just mean that you owned the stock, and you get dividends from it. Anybody can do that. Frankly, the point is, is it has to have a strong close connection.

You know, as at the -- as at the Court said in -- in Hoechst Celanese, you know, they talked in terms -- wonderful terms, we need to keep in mind, the touchstone -- the touchstone here of determining whether it's business or non-business interest income is really looking at this relationship. They also use the terms organic unity, that there must be organic unity between the stock and AT&T's unitary business operations, whereby the stock contributes materially to AT&T's unitary business. It's not just the size of the dividends. That -- that's not the issue here. You know, ASARCO and Woolworth made that very loud and clear in their opinions there, the Supreme Court. You know, all investors who -- who has stock received dividends, and they could be large or small. That's not the point.

So, as we said really, like at the beginning of our argument and as we've said it throughout the briefs, there really is no limit to the FTB's position. The fact of the matter is the law requires more and requires a close -- a very close connection between that property and the unitary business. That's what's missing in this case here. Nothing that FTB said yesterday changes that

argument. Because let's just step back a second. If you own stock in a particular company and you decide to do business with it, does that automatically make the dividends business income? No. There's a bigger analysis, a deeper analysis that must go. And I think that's what the FTB is -- does not want to do frankly.

In -- in our briefs, what we have said is that, you know, we -- we've looked at the terms that the court said in Hoechst Celanese. You know, the stock must be interwoven into the fabric of AT&T's unitary business operations. That stock becomes indivisible and inseparable, you know, from the unitary business operations. There has to be flows of value going in both directions here. So, I -- I think what the point is, is that what did we have here? We had essentially a 10 percent -- 8 to 9 to 10 percent stake in each of these three companies. We couldn't control a doggone thing here in these companies. Mr. Helú was strongly in control then. He's strongly in control of America Móvil today. We were allowed to invest. We were allowed to invest and get there -- get the dividends from that. That does not make those dividends automatically business income.

So, I think that the -- the issue that -- that we have is that the FTB really has presented no evidence that the stock has contributed materially to AT&T unitary

business ops -- operations. It's just the opposite. You know, we've given some examples of where the courts, the Board of Equalization, the U.S. Supreme Court, California Supreme Court where you got that connection there. Those are the -- those are the guidelines we have to deal with here. And -- and I think, you know, let's -- let's step back and think about what some of these cases talked about. You know, they talked about like Standard Oil, real interesting. The classic situation there. You know, you have basically have stock in companies that are going to be supplying you your crude oil and you're -- you're natural gas, and that was like a 50 percent of it. You owned the stock, and it was directly the amount we got -- Standard Oil got as of -- of natural gas and of crude oil there, was tied to the ownership interest there. The facts of Standard Oil are very, very well worth looking at one more time.

Is there, you know, a supplier of other -- other items here? We had American built right case, which is a good one to be looking at as well. And I think that the -- the terms that even was used by the BOE in -- in Mark Controls, they talk about no special advantages or benefits. They talk about price breaks. We don't have any of that here. The fact of the matter here is yes, AT&T did business with these entities, but it was not

significant when all was said and done. You can go through each of the 10-Ks for AT&T and go through the 20-Fs for each of the other entities here, the investees, and they're all in -- they're all in the record.

So, you can look at it easily there, and you'll find there's no discussion about the connection being so doggone strong about the related parties' transactions. I -- I love the related parties' transactions in -- in the 20-Fs. They basically are talking about transactions between either Telmex and Telmex Internacional, or Telmex with American Móvil, or with Carso Global, not with AT&T. These were not significant. I mean, when we talk about the -- the percentage of the revenues of AT&T's revenues that are represented by the investments in these entities here, as I said yesterday, it's in a category called other. It's not exactly an operational category the way I look at it. And it's less than 1 percent of the overall revenues.

Now, these -- these are basically the revenues, I think, consulting agreement services there, the payments for that. Again, there's a real absence of proof by the FTB. You just can't say it's big dividends, so doggone it we got to get a piece of that. That's not the law. So, when we -- when we look at this, you know, I think it's really quite good to kind of delve into the facts that are

in record here, and they are facts that I think I would -- I would suggest strongly that the panel be very aware of it.

So, what I'm gonna do is I may have mentioned yesterday of the declarations that -- that we have had filed in -- in this case. And they are helpful. They're not lengthy, but they are helpful because these are all individuals who were at AT&T during the years at issue; and they can speak to the relationships between AT&T and these investees. Mr. Moreira, who I mentioned to you yesterday, which I believe is Exhibit 50 is what is in the record right now. Mr. Moreira was the chief counsel of the Caribbean and Latin American region for AT&T services since June of 2007. He joined AT&T's legal department in May of 2000, and at that time that was SBC Communications, just to keep our names straight here. In June 2007, he was transferred to AT&T's Global operations legal team.

Mr. Moreira's responsibility was for developing and supporting all regulatory compliance and external affairs matters in relation to the corporate enterprise sales for AT&T through the Latin America region. He provided legal and regulatory guidance to AT&T's sales and product teams on a corporate enterprise global solutions. During the two years in issue here, '07 and '08, he was also responsible for supporting all retail and procurement

contracts, billing, and other support functions related to the corporate enterprise retail sales of AT&T services throughout Latin America ensuring compliance with AT&T's processes and local contracting laws.

Beginning in 2008, the second year of our -- of our appeal here and all the way through 2014, he had direct contact with Telmex with respect to the legal management of the 2007 Framework Agreement and the subsequent 2013 Framework Agreement between AT&T and Telmex and American Móvil. I should explain that. That -- that's the second Framework Agreement. It's obviously not during our years here. It's 2013. Mr. Moreira spoke or discussed both of these agreements in -- in his declaration here. And that was -- the reason why there was a second one is that there was a merger between Telmex and America Móvil. As I indicated yesterday, by the time we get to 2014, AT&T doesn't own any stock in any of these entities. They've actually merged, or whatever, and finally they sold the stock of America Móvil in 2014.

The relationship, according to Mr. Moreira, between AT&T and both Telmex and America Móvil under those Framework Agreements was arm's length. He said further, AT&T and Telmex were competitors in the corporate enterprise market. Competitors doesn't sound exactly like

a unitary relationship to me. I don't know about you. They sought the same customers. Indeed, there was a level of distrust -- these are his words -- between AT&T and both Telmex and America Móvil, which continued until the sale of America Móvil in 2014. He says he was very familiar -- this is paragraph 7 of his declaration -- very familiar with the 2007 and '13 Framework Agreements between Telmex, America Móvil, and AT&T.

The main aspect of these agreements was to allow AT&T and Telmex/America Móvil to establish network-to-network interconnections -- and they're called NNIs -- in Latin America. Under the Framework Agreement, it was contemplated that AT&T would purchase access from Telmex and America Móvil and use their respective networks in Latin America to service AT&T's corporate enterprise customers, AT&T's customers. There was a corresponding Global Master Carrier Agreement called a GMCA, included therein which Franchise Tax Board mentioned yesterday, which covered AT&T's purchase services from Telmex and America Móvil. That agreement was a standard local access agreement according to him.

Paragraph 8, he says the Framework Agreements were arm's length agreements. They were not exclusive. Now what? Is that important? Yeah, it is important. We're getting back to the benefit. What is this benefit

that we're talking about that owning the stock? Neither party under the Framework Agreements were obligated to purchase services from the other party under those agreements.

Paragraph 9, Mr. Moreira says AT&T had local access agreements and backbone agreements with many other carriers in the region -- Latin America region again -- which allowed it to create the AT&T Global Network in Latin America.

Paragraph 10, he says article 7.9 of the Framework Agreement, to which Franchise Tax Board referred, stated that quote, "The parties have agreed to joint go-to market strategies and joint account planning as detailed in the parties' joint service and collaboration agreement," -- and that's letters JSCA -- "and incorporated into this agreement by reference." The JSCA was never adopted by the parties.

Paragraph 11, Mr. Moreira says, "AT&T was not dependent upon Telmex/America Móvil to service its customers. AT&T already had its network," -- and that was the AT&T Global Network, the AGN -- "and already had the ability to put customers on their own network." He says that -- he refers again back to paragraph 8 where it says the Framework Agreement was not exclusive. AT&T leased access and capacity from other telecommunications carriers

besides Telmex and America Móvil. That's the non-exclusivity. AT&T could use any number of other telecommunications carriers besides Telmex and America Móvil and had relationships in place with other carriers in the region.

Paragraph 13, AT&T's global access management teams reviewed on an annual basis whether the cost structure with the outside carriers, including Telmex and America Móvil, remained market competitive and regularly renegotiated the pricing structure based on the evaluation of the marketplace. Doesn't sound like to me there was a whole lot of price breaks here on this. "The Framework Agreements did not," Mr. Moreira says, "in of themselves create new customers for AT&T. They simply provided another way of servicing customers that AT&T already had." The Framework Agreement did not create more business, according to Mr. Moreira, within the U.S. for AT&T. Telmex/America Móvil did not purchase a significant amount of the NNI services in the United States from AT&T because AT&T was more expensive than other U.S. carriers. It doesn't sound like we're talking about some kind of an advantage or economic benefit here. His last paragraph says, "From a business standpoint I never saw that AT&T realized any operational advantages because we owned an interest in Telmex and America Móvil."

The second declaration I would like to refer to is at Exhibit 58, and it's the declaration by Simon Xu, and that's spelled with an X-u. And Simon, at the time he signed this declaration -- and this has been around a long time -- 2015. This was during the protest of this case. Mr. Xu says, "I'm currently the executive director of AT&T's Mobility and Business Solutions Group, responsible for the international strategy and business investment of that group. In this position, I'm involved with establishing network to network and interconnections," -- the NNIs again -- "of ongoing operations, management, and governance and working with AT&T sales and marketing departments."

Paragraph 3 says, "Legacy SBC" -- again, remember that was the name of AT&T before the 2005 merger and everything. "SBC had a Framework Agreement with Telmex," -- so, this is 2005 -- "that was specific to Mexico. After the merger with AT&T corporation in 2005, legacy SBC inherited a Framework Agreement from legacy AT&T. Under the Framework Agreement between AT&T Corp. and Telmex, AT&T setup an interconnect with Mexico and later Brazil. However, the two NNIs were not generating revenue until at least 2008." We've submitted an Exhibit 40 which shows there was no revenues on those NNIs but realized by AT&T during the years in issue.

Mr. Xu says the following, "In 2011, America Móvil acquired Telmex. Subsequently" -- now this is mentioning to you about the fact when we needed a new Framework Agreement. "Subsequently, AT&T entered into a Framework Agreement with America Móvil as of 2013. This agreement superseded the 2007 agreement -- Framework Agreement with Telmex with changes to reflect the names of the new parent." Very similar language in much of the agreements.

Paragraph 5 of Mr. Xu's declaration, "There were four aspects to AT&T's Framework Agreement with America Móvil. The first covered the expanded NNIs," I have already mentioned. "AT&T expanded interconnections beyond Mexico and Brazil to cover its region-wide network interconnections that covers 16 countries, and with 6 -- with 5 connection points. The expanded interconnections occurred at the end of 2013." The second aspect of the Framework Agreement, according to Mr. Xu, covered ways to improve customer experience and efficiencies by improving systems and technology. The third aspect of the agreement covered pricing between the two parties. The agreement was an arm's length agreement, according to Mr. Xu, and there was no exclusivity, one more time, between the parties.

Finally, the Framework Agreement covered

high-level overarching guidance on the go-to market and sales opportunity processes. However, there was no actual joint marketing or co-marketing between the two parties. Again, where is the connection here about benefits, advantages, and things.

Paragraph 9 of Mr. Xu's declaration says, "The Framework Agreement gave America Móvil/Telmex the ability to purchase services from AT&T in the United States" -- excuse me. "However, America Móvil and Telmex did not generally use AT&T as a supplier in the U.S. because AT&T could not compete with other carriers on pricing." Similar to what Mr. Moreira said. There was also a governance provision in the Framework Agreement. AT&T and America Móvil had quarterly and monthly meetings, but these were not official meetings as there was no quorum requirement or voting on items. He indicated the meetings were generally about best practices for the program and project management. The discussions covered delivery timelines for NNI services, meeting deadlines to deploy NNI technology necessary to meet demand.

Paragraph 12 of Mr. Xu's declaration, he says, "Governance meetings with America Móvil and Telmex were consistent with how AT&T governs all of its relationships with carriers around the globe," and those are carriers that are not -- there's no stock owned there, just merely

third parties. For example, AT&T has a Framework Agreement with China Telecom, which had similar governor -- governing procedures -- provisions -- excuse me -- and committee meetings. They don't own an interest in China Telecom.

Then he talks about AT&T suppliers in Mexico and Latin America. In paragraph 13, he says the Framework Agreement allowed AT&T to purchase capacity from America Móvil and Telmex in Latin America to service its customers, but it was not an exclusive arrangement again. In Latin America, Mexico and Brazil were the largest markets for AT&T.

Fifteen -- paragraph 15, "AT&T had many other suppliers in Mexico and Latin America besides America Móvil and Telmex." Not exclusive, as I've indicated. "AT&T had interconnections with suppliers all over the world but does not use a sole provider in any market. To do so would violate many of our business principles," according to Mr. Xu. And finally, he says, "AT&T selected carriers using a competitive bidding process based on pricing and quality. Similar to what Mr. Moreira was saying.

The third declaration is the declaration from Steven Taylor, and that is Exhibit 59. And this was also executed in 2015. At that time, Mr. Taylor was the

assistant vice president of AT&T Inc.'s global connections management group. His sole -- his role was to purchase local access data services globally, including Latin America from Mexico down to the southern tip of Argentina. He currently managed purchasing such data, and there was a separate group that dealt with purchasing voice services. The data group coordinated the purchase of local access data circuits.

Under the heading "Global Master Carrier Agreement between Telmex and AT&T Corp." -- and it's schedule 4 to the 2007 Framework Agreement between Telmex and AT&T. The -- the GMA group deals with Global Master Carrier Agreements. It's an arm's length agreement between Telmex and AT&T. This particular agreement was exclusively for the purchase of services from Telmex to connect AT&T's nodes to the customers' location in Latin America. AT&T has a network of nodes around the world, including Mexico. However, a customer wants AT&T to provide service in Mexico, AT&T has to buy access from a third-party local carrier for the last mile that it does not own. And that is not just Telmex or America Móvil, it was a third-party carrier.

Legacy AT&T Corp. only had one supplier in Mexico until 2011, three years after our period. And that entity was called -- named Alestra, A-l-e-s-t-r-a. AT&T divested

its interest in Alestra in 2011 and subsequently, started using other vendors to provide local access services in Mexico. Currently, 2015, AT&T has five vendors. Now, keep in mind, 2015 after we owned no stock in America Móvil or any of the others. He says, "Currently the five vendors for local data access in Mexico in the post-2011 environment: Alestra is still a provider, but also -- very interesting, America Móvil, a provider, Nextel, Metrored, and Readit IT -- I don't know those entities. The one that caught my eye is America Móvil, one year after we sold the stock."

Mr. Taylor also talks about the competitive bidding process that AT&T had, and that was for a selection of vendors. AT&T uses -- at paragraph 9, it uses a competitive bidding process to purchase capacity from America Móvil and Telmex or any other carrier -- any other carrier in Latin America to service its customers, and does not give any prefer preferential treatment to one carrier over another, and that includes Telmex and America Móvil.

Paragraph 10, he says the competitive bidding process for awarding a circuit to all carriers generally starts when AT&T receives and request from an enterprise customer for services which would require AT&T to use a third-party carrier. AT&T would send a request for a

quote from all the carriers, and based on the quote, AT&T build -- would build an offer to the customer. AT&T wins the business, it finalizes the bidding process with the carriers to secure the best and final price. AT&T will award the circuit to a carrier based on the price and the quality performance of the carrier. The group he was VP of, "The function was to reduce cost," he said. "And we were always negotiating cost reductions with carriers around the world."

Paragraph 12 of Mr. Taylor's declaration says that, "AT&T would purchase data circuits for a 12-month period, but the circuits often stay in place for longer. If the carrier that currently has the circuit is not willing to remain market competitive, then AT&T will try to migrate the circuit to another carrier." We're talking not just America Móvil or Telmex, we're talking about any carrier in which they deal with.

Paragraph 13, pricing varies year by year and sometimes one carrier is more aggressive with its pricing. Generally, carriers are comfortable with a certain market coverage, and the market changes as AT&T does its bidding. The carriers tend to react when they are winning less business than they used to, which is not surprising. They respond by lowering their price to restore their prior level of revenue. Under a section he labels "America

Móvil Telmex's Purchases from AT&T," he says the following, paragraph 14, "America Móvil/Telmex also used a similar competitive bidding process to purchase circuits from third-party carriers in the U.S. to service its customers in Latin America."

Paragraph 15, he says "America Móvil and Telmex generally did not purchase significant services from AT&T." And finally, he says, "America Móvil generally purchased services from other lower priced U.S. carriers over AT&T."

Why did I go through all of these guys? This is evidence. This is evidence that there's no price breaks, no advantages, no whatever, according to three individuals that were on the ground during these years. And I think this -- this is really where the, you know, the essence of what -- what this case is all about. As -- as I said, I think we have to delve in very carefully about the terms of the agreements and also about exactly what does the other pieces of evidence in this case show. So, as -- as indicated by these -- these gentlemen here, you know, I talked about the Framework Agreement. Framework Agreement is very typical of what kind of agreements existed with AT&T and these third parties.

Every one of the agreements that I've been able to read -- and they're all in the record that I've seen,

and that would include agreements like the -- the Tracfone reseller agreement, which FTB is referring to. They refer to the Sección Amarilla agreement was well. Interestingly, they've cited to that agreement, and it came in place in October of 08. Not exactly directly relevant to our years, but that agreement -- they're all non-exclusive agreements. They're all arm's length agreements. So, the terminology is very important to -- to look at this. And they had these kinds of agreements throughout the world like this. The -- then there would be unrelated companies, needless to say, and that I think is the key here. Much like what they did after '14 with America Móvil.

When you review the 10-Ks, and you review the 20-Fs, you don't see references to the agreements between AT&T and America Móvil and Telmex in there. These agreements were -- were all, you know, wonderful and things like that. There is lots of good things in there. There's lots of aspirational things, like Mr. Moreira was talking about. I think that's the real important part about what really happened during the years in issue. So, as we indicated yesterday -- and I -- I can't emphasize this enough -- the entities, the Mexican investees, were all controlled by Carlos Slim Helú. Mr. Helú controlled -- it's virtually everything having to do with

the tell -- telecommunications industry in Mexico.

We had a minority interest, and all that really gave us, frankly, yes we got 2 seats on the board of each of these out of 12. Did we control anything? No way. Not at all. Again, what do we describe our interest in these entities in our 10-Ks? Consistently, we describe them as investments. There's no -- there's no -- they're making no bones about it. We -- we need to, you know, very nice investments in these companies over the years. And I will get into that a little bit more as well.

I think that the other part about this is that AT&T and FTB has referred to this, mentioned the funds that we received from Telmex for the consulting services that we provided. And we indicated yesterday that the percentage of revenues related to the consulting services is less -- well less than 1 percent of AT&T's revenues here. Remember what we have to look at here for business and non-business income. Is there -- is there a contribution -- material contribution -- contribute materially is what Hoechst Celanese says. That's not material when we're talking about it. These were arm's length charges as well.

So, I think as well, when we talked about it, and here again, I'll -- I'll reiterate that the fact that we do business -- and this would be anybody -- does business

with somebody we own stock with, that doesn't automatically make the dividends we received business income, contrary to what FTB's position. The -- again, how do you try to show that? How do you show that there's an integral relationship? Well, that's the items that we mentioned yesterday where Hoechst Celanese with the attracting employees and retaining employees. That's what the pension assets were. Standard Oil, the stock with the supplier, America Biltrite, similarly. Again, the language in Mark Controls talks in terms of -- you know, it says why -- why this is not business income because we don't find any of these pricing advantages, special advantages here.

So, let me -- let me address a few of the items -- other items that the FTB raised yesterday. And the first item I'm going to talk about, this is the CTS Keen case that FTB is relying on very heavily in this matter. Now, as -- as Your Honors fully understand, we've written an awful lot in this case -- both sides -- and we've talked a lot about CTS Keen. I'll -- I'll try to give a short summary of why CTS Keen is completely distinguishable from what we're talking about here. The fact -- the facts in CTS Keen is they're very interesting. They're very important to read. In CTS Keen, unlike the present appeal, there was an operational benefit received

by the taxpayer's parent CTS Corp. in connection with its ownership of stock in AB Electronics components.

In 1965, 17 years prior to the years on appeal, CTS had entered into a licensing agreement with AB to manufacture products of CTS and its subsidiaries, CTS Group, in Great Britain and to market them in Great Britain, to manufacturers and to sell the CTS's groups products in Europe. The activities of -- of a German subsidiary, that was -- excuse me. CTS formed a German subsidiary to manufacturer and sell those products in Europe. The activities of the German subsidiary was in competition with AB's activities in Europe, and then that caused friction between CTS and AB. To resolve the conflict, CTS sold its German subsidiary in 1970 in exchange for 10 percent of AB stock. At the same time, AB and CTS modified their existing licensing agreement and executed a new licensing and sales representation agreements, which granted to AB full manufacturing and selling rights in Europe for the CTS Group's patents, trademarks, and no how, in the fields in which AB operated.

There was evidence presented in the case that the purpose of the stock purchase was to provide CTS the opportunity to expand its marketing and manufacturing operations in Europe. In 1979, CTS purchased an

additional 450 share -- 450, 000 shares from AB, thereby increasing its ownership interest to 20-and-a-half percent. This is very critical here. The subscription agreement concerning these shares reiterated that CTS and AB mutely desire to extend their present cooperation and to progress further the successful relationship that has for many years existed between them.

The next part is crucial. The agreement was expressly condition upon the execution of a new licensing agreement. And we're talking about the agreement to purchase the additional shares of stock; an execution of a new licensing agreement between AB and CTS covering new products developed by the CTS Group, and upon extensions from 1985 to 1990 of the expiration dates of the prior licensing agreements. In 1982 -- so, three years later -- they sell the stock, CTS does. Question, is that a business income transaction or a non-business? So in concluding, the gain from the sale of the stock was business income. BOE focused on, quote, "The clear connection," -- their term -- "clear connection between CTS's stock purchases, the licensing agreements, and the promotion of CTS products in Europe." Specifically BOE stated, "This appeal involves the application of the functional test for determining business income."

On the facts presented, we agree with Respondent

that CTS's stock holding in AB was integrally related, there's our phrase again -- integrally related to the CTS Group's unitary business and was an asset that served an operational function in that business, rather than merely an investment function. When we look at this case, it's 1993, that -- the phraseology sounds like it came right out of Allied Signal Supreme Court. The BOE went onto say, "The evidence establishes a clear connection between CTS's two purchases of stock, both the one in 1965 and the one in 1979. And the licensing agreements between the two companies, agreements which expanded AB's manufacturing and marketing of CTS's products in Europe, and which generated royalties to CTS that undoubtedly constituted business income here. CTS's real goal was not to achieve a return on the stock itself" -- this is the BOE's language here -- "but rather, to support the AB's efforts under the licensing agreements to help create a broader worldwide market for the various products developed by the CTS unitary group. CTS accomplished this goal by supplying capital to AB, transferring the assets in cash in exchange for newly issued AB stock."

It's very interesting. This is newly issued stock. Really, when you're buying stock, you know, and here -- here this -- this -- the funds you're going in to buy this newly issued stock would be directly related to

AB or directly available to AB itself. That's not quite what happened with AT&T and the privatization of these Mexican investees. It put AB in a stronger position to enhance the sale of CTS products in Europe. There's a pretty close connection here -- clear connection.

CTS's business goal was fully accomplished by becoming a minority shareholder in AB. For in doing so, it supplied new capital to AB and thereby, assisted AB's efforts to become a more effective promoter of CTS's products in Europe. Thus, the AB stock was fully integrated. The stock was fully integrated, and fully integrated asset of CTS's unitary business.

So, I mean, a couple of things hit me here. Counsel is going to discuss, or they have discussed in their briefs Mr. Witacre, the former CEO of the company and his book that talked about purchasing all sorts of companies and assets, et cetera. He wanted to get bigger like that, and that was his main thing. And the idea was there was investments, and we'll talk about that in a bit more here.

JUDGE HOSEY: I'm gonna have to stop you there. I just wanted to let you know we're about 40 minutes in.

MR. VESELY: Okay.

JUDGE HOSEY: We're gonna have to be careful with time today. We have one, two, three, four, five other

issues to get through, including --

MR. VESELY: Okay.

JUDGE HOSEY: -- another big one. And we did agree to -- I think it was four hours each for main oral arguments and rebuttal was down to like an hour. So, we're getting kind of tight on time.

MR. VESELY: Fair enough.

JUDGE HOSEY: So, if you could summarize the rest of the rebuttal, we got to get questions.

MR. VESELY: I will -- I will --

JUDGE HOSEY: Okay.

MR. VESELY: I will abide by your needs there.

JUDGE HOSEY: Thank you Mr. Vesely. I appreciate it.

MR. VESELY: Bottom line is CTS Keen is directly not on point, frankly. It is distinguishable, the facts. And I think that the license agreements there are tied to the stock. That's the connection here.

Now, in passing, the FTB made -- made reference to the Federal Communications Commission Order. That's in record itself. It talked in terms of where the Commission made a comment about the consulting agreements and whether or not there was arm's length relationship between America Móvil and AT&T. I would call the Court's attention to the fact that the order in that case was all linked to whether

or not they would allow AT&T to purchase an interest in a Puerto Rican entity there, in a country in which they were competitors with AT&T -- with America Móvil. And indeed, that's -- that's really what that order was all about. Competitors are not exactly a unitary relationship here.

Going on to that, the FTB cited to Occidental Petroleum. Occidental Petroleum however, is very relevant and supportive of our position. And I think that is quite important to keep in mind here is that in Occidental Petroleum we're talking about the sale of stock in entities that were unitary members of the Occidental Petroleum unitary group. Well, the sale of stock of a unitary member is right -- right in the wheelhouse of what's business income. There's no question about that. And you still -- the focus is on the stock there.

I mentioned Mr. Whitacre, and I -- I think it's very interesting. He -- there's a Forbes article that we had referred in the -- in the briefing. And his -- his quotes in that article -- "this was December of 2006. And it was regarded the investments in Telmex and America Móvil. In late 1990. Southwestern bell became the first Bell to invest outside the U.S. It paid $962 million for a 10 percent stake in Telmex, the biggest teleco, in Mexico, controlled by Carlos Slim Helú." This is Mr. Whitacre's words. "This investment has grown to

$10 billion in the form of an 8.2 percent stake in Telmex, and a 9 -- a 7.9 percent stake at that point in America Móvil. It had $2 billion in equity sales, plus 15 years of dividends."

"Subsequent to 2006, that investment continued to grow until 2014 when AT&T sold its shares in America Móvil. The overall return on AT&T's investment in Telmex, America Móvil, and Telmex Internacional was outstanding. For 1990 to 2014, 25 years -- 24 years -- AT&T invested $1.2 billion in its return on investment which include the dividends was $12.8 billion. Again, the other exhibit that was in the record here were parts of this book called America Turn Around." Mr. Whitacre was very clear -- and that's what we've mentioned this in our briefs -- that his goal in investing in Telmex was to provide value to the shareholders and to increase and diversify the company's asset base. As he stated, "Telmex turned out to be a wonderful deal, just like we thought it would. So good that we doubled down on our investment within a year."

After disclosing some other investments that he -- that the company had, Mr. Whitacre went on to say, "We got big. We got real big, and that's what -- by the time I retired in 2007, AT&T was the largest communications company in the world with annual revenues of around $120 billion. Our investments are buried in

deep. We also own a respected portfolio of investments in foreign countries, including Mexico, Israel, South Africa to name a few."

It's very interesting. Mr. Whitacre's comments are -- are remarkably similar to the arguments that were made by the New Jersey Department of Treasury in Allied Signal in support of its position that gains from the sales of stock should be classified as apportionable income. In rejecting those arguments, the U.S. Supreme Court compared New Jersey arguments to those made by the state of Idaho in ASARCO, and stated the following. The Court said, "The mere fact that an intangible asset was acquired, pursuant to a long-term corporate strategy of acquisitions and divestitures, does not convert an otherwise passive investment into an integral operational one."

Apart from semantics, we see no distinction between the purpose test that they rejected in ASARCO, and the ingrained acquisition divestiture policy approach adopted by the New Jersey Supreme Court. FTB has never been too excited about the fact that we have referred to the U.S. Supreme Court decisions in ASARCO and Woolworth and Allied Signal. Well, it's very interesting because one, it's U.S. Supreme Court, and they're talking about whether dividends should be apportionable or not, business

income or not.

These cases, along with Mobile Oil are the really the keys -- the cases in this area that the States, California and the Board of Equalization, must need follow. It's very interesting to look at the Hoechst Celanese case real quickly about the whether or not it's important or relevant to look to the constitutional authorities here like that. While the Court says, "Even though Hoechst Celanese's reversion of surplus pension plan assets falls within the statutory definition of business income, subjecting the income from the reversion to taxation must still pass constitutional muster. Under the due process and commerce clauses, a state may not tax value earned outside of its borders. The taxpayer bears the burden of proof showing by clear and cogent evidence that the state tax results extra territorial values being taxed."

The Court here does as explained below, Hoechst Celanese does not meet this burden. Therefore, an apportionment of income from the reversion is constitutional. So, it's important to be looking to what the U.S. Supreme Court has said. Also, I should call your attention to the Court, as I've said yesterday, is the FTB does not take the opposite position of these entities. There's no unitary relationship between AT&T and the three

Mexican investees. They agree to that. And I think that -- that is it. And an important point that we need to keep in mind here.

JUDGE HOSEY: All right. Looks like we're getting past time here. Are there any final statements you'd like to make before we move on?

MR. VESELY: I got -- I've got my last statement here for you.

JUDGE HOSEY: Okay. Let's do it.

MR. VESELY: Okay.

JUDGE HOSEY: Thank you.

MR. VESELY: So, here -- here's what we've got in this case. AT&T held a -- a minority interest in Telmex, America Móvil, and Telmex Internacional for 24 years. They received significant dividends, as I've already indicated. There's no question that Carlos Slim Helú was the person in charge of these entities. AT&T always described its holdings in these entities as investments in their 10-Ks. They then sold the stock in 2014, and interestingly enough, still maintained the same commercial agreements what they did beforehand with America Móvil, the one I mentioned in the briefs already. So, you step back and say how was the stock integrally related to -- to AT&T's unitary business? There's no special price breaks. There's no special advantages. All the evidence indicates

we aren't -- we don't fit into that cubbyhole here.

The Franchise Tax Board does not like the fact that the BOE ruled against them back in 2011 for 2001 and '02. The interesting part about it is they really haven't said what is -- what are the difference in the facts. Because even after that, they enter into a closing agreement, which is in Exhibit 56 in our case here; and a closing agreement where America Móvil and Telmex dividends were agreed to be non-business income from 2003 to '06. What has changed? I think the idea here is that nothing has changed here; the same relationship that existed. And regardless of whether we want to look to the SB -- BOE decision or not, we have -- we have sustained our burden of proof here of proving that the stock that AT&T held in these three entities was not integrally related to AT&T's unitary business operations and did not contribute materially to those operations.

Thank you.

JUDGE HOSEY: Thank you.

I'm gonna go to my panel to see if there's any questions, starting with Judge Lambert.

JUDGE LAMBERT: I have no questions. Thanks.

MS. TAMAGNI: Excuse me, Judge Hosey.

JUDGE HOSEY: Yeah.

MS. TAMAGNI: Will we have an opportunity to

rebut after you ask questions or --

JUDGE HOSEY: Yeah. Let me --

MS. TAMAGNI: Okay. Thank you.

JUDGE HOSEY: I was gonna see there were questions first.

Judge Gast, any questions for Appellant?

JUDGE GAST: No questions at this time. Thank you.

JUDGE HOSEY: Thank you.

Franchise Tax Board, did you want to address some points?

MS. TAMAGNI: Just three quick points. There we go. Three points.

REBUTTAL ON ISSUE NO. 2

MS. TAMAGNI: So, again, looking back at that closing agreement that was done for tax years '03 through '06, that agreement is not relevant to the legal analysis of the current tax years. As shared by the Appellant, this agreement covered many issues, and many different considerations going into the drafting of a closing agreement between two parties. Appellant knew, at the time they entered the agreement, that it would only cover tax years 2003 through 2006. So, this was not an open-ended agreement. And this was not a Chief Counsel

ruling, and I think that's an important distinction. This covered and only covered tax years 2003 through 2006, which are not the years of today's appeal.

The second thing I'd like to bring your attention to is that we -- I mean, we're asked -- we're looking here what is -- what is non-business income? What is business income? And it is Appellant's burden to show that this is non-business income. In the regulations, there are some examples of what is business income and what is non-business income tax. And under Regulation 25120 subsection (c)(f), that's the part that discusses dividends. In example 4, it gives a good non-business -- non-business income example that I'd like to point to you. It discusses a taxpayer engaged in a multistate glass manufacturing business. It holds stock and interest-bearing securities which are unrelated to its glass business. The dividends and interest income are non-business income.

The facts presented in today's appeal are very different from this example. This example emphasizes that stock and securities need to be unrelated to a taxpayer's regular trade or business. And -- and in this example, the Appellant -- the taxpayer and then whatever business its holding the entities in, they're clearly not a glass manufacturing business.

Here, we have Appellant and these entities, Telmex, America Móvil, Telmex Internacional, they're not unrelated. They're not in different industries, as we've shared in detail in both our presentation and in the briefing. They've very much connected, and these connections are why the dividends from the stock should be classified as business income. Appellant does not need to be unitary with the entities that it owns stock. And Respondent is not arguing that Appellant is unitary with them. We're not attempting to add America Móvil or Telmex or Telmex Internacional to Appellant's combined report. That is not what we're doing.

Instead, we're showing you legal authorities that say that such a connection is not required to be in place for these dividends to be considered business income. In Allied Signal, the Court held that income can be included in the apportionment base. So, can be included in business income if the capital transaction, which would be the stock, serves an operational, rather than an investment function. The Supreme Court also stated in Allied Signal that the payor and payee do not need to be in a unitary relationship in order for this item of income to be classified as business income.

So, what needs to be shown is that the acquisition, the management, the disposition of this

income-producing item, here the stock, was integral to taxpayer's regular business activities. Because of Appellant's stock ownership, it had voting rights. It had the ability to put its highest and most valuable employees on boards and executive committees of the companies in which it held stock. Without the stock, it may have been able to engage in business with these entities, but they would not have been able to add its own employees to the boards and the executive committees of Telmex, America Móvil, and Telmex Internacional. So, the stock ownership, it aided in Appellant's collaboration with these companies. The stock was integrally related with AT&T's business operations and accordingly, it served an operational function because AT&T was able to achieve its goal of expanding its telecommunication business.

And that is why Respondent respectfully request that you find that the business -- that the dividends from this stock be classified as business income.

Thank you.

JUDGE HOSEY: Thank you.

Mr. Vesely, a few minutes.

MR. VESELY: Very quickly.

JUDGE HOSEY: Thank you.

MR. VESELY: Thank you, Your Honor.

///

REBUTTAL TO ISSUE NO. 2

MR. VESELY: I think that the last point is what I really want to talk about real quickly. The items that the FTB doesn't like hearing about in this case is these things called the factors of profitability. And these things are centralized management, functional integration, and economies of scale. In the opinions of ASARCO, of Woolworth, of Allied Signal, ASARCO, Mobile Oil, there's all these discussions about functional integration. Yes, it's -- it's a term we use in the unitary business determinations and everything else. But the fact of the matter is -- and we've -- we've cited it in our briefs. I will not bore you with reading part of it again.

But take a look again of what the Court said in both Woolworth and Allied Signal in particular about that these are still very important items here, and we're talking about whether the dividends in Woolworth are they stock? The gains from the sale is stock in Allied Signal were business income or apportionable income here. Those are very relevant items here. The fact that they're all absent in this case just further supports AT&T's position.

Thank you.

JUDGE HOSEY: Thank you.

I'm just gonna just make sure we -- I'm gonna go to my panel for final questions before we go to the next

issue.

Judge Lambert, any questions for the parties?

JUDGE LAMBERT: No questions. Thanks.

JUDGE HOSEY: Judge Gast, any questions for the parties before we move on?

JUDGE GAST: No questions as well. Thank you.

JUDGE HOSEY: Okay. I don't have any either.

Do we want to take a quick break before we move on? All right. We'll take a 10-minute break. It's 10:03. So, 10:13 we'll back, and we'll start with Issue 3. Thank you.

We are now off the record.

(There is a pause in the proceedings.)

JUDGE HOSEY: We are now back on the record in the Appeal of Pacific Bell Telephone Company.

We are moving to Issue 3, and we'll start with Appellant's oral arguments.

You can begin when you're ready.

MS. HUANG: Judge Hosey, I will be taking the issue.

JUDGE HOSEY: Thank you.

MS. HUANG: And being mindful of the time, and we do appreciate your -- your patience, we're just -- this will not take that long.

///

PRESENTATION ON ISSUE NO. 3

MS. HUANG: Okay. So, on this issue, I know there is a little bit of disagreement on how to phrase the issue. So, we will simply phrase it the way we think it should be. So, pardon me if that does not agree with Respondent's phrasing of the issue.

So, on this issue, it is about whether BellSouth was unitary with Cingular or AT&T Mobility. And just for -- for ease of discussion, I will simply call them Cingular. So, on its original California return for tax year 2007, consistent with its prior returns for 2001 through '06, BellSouth filed a combined reports excluding BellSouth Mobile Data and affiliates, which we'll call BSMD, because they were not engaged in the unitary business. On October 2000, SBC and BellSouth spun off their representative former wireless operations from Cingular. So, after that spinoff, BellSouth no longer had its own wireless operations.

So, BSMD held 40 percent minority interest in Cingular and SBC owned the other 60. Cingular operated a nationwide wireless network and operated autonomously from its two investors. Accordingly, BSMD's wireless investments in Cingular was a separate trade or business from BellSouth primary trade or business, which was wire line service in 2007. Due to the fact that Cingular was

owned by two separate and unrelated public companies in a highly competitive telecommunications industry, neither BellSouth nor SBC were able to control Cingular as they had equal voting rights.

In fact, it was generally easier for Cingular to engage in transactions with an independent third party than with either one of them, you know, SBC or BellSouth. So -- and all transactions between Cingular and BellSouth, or SBC even, were at arm's length to ensure that no transaction or agreement would favor or even potentially be considered to favor one owner over the other. Furthermore, there are fundamental differences in technology and provisional services between wire line and wireless telecommunications. So, there was no sharing of equipment or technology between BellSouth and Cingular. For instance, where line communications, as you may know, it starts at the premises of a customer and rely on wires, such as copper, fiber optics, to run between the calling parties through a system of telephone switches. On the other hand, wireless telecommunication services commence with a wireless handset called to a cell tower and rely on the use of radio spectrum and other cell towers.

And so, like I said, there was no sharing or -- so, let me go to the next one. There was no sharing of or transfer of personnel between BellSouth and Cingular, no

common marketing or branding between BellSouth and Cingular. Cingular performed its own administrative functions. There's no -- oops. What happened?

MR. VESELY: Sorry.

MS. HUANG: That's okay.

Anyway, there was no centralized cash management between BellSouth and Cingular, inner company transactions between the two of them were insignificant, and equipment and office locations were separate. So, every meaningful aspect of Cingular's business operations was conducted as a fully separate standalone -- oh, typo. Sorry -- standalone business enterprise and managed independently by Cingular's officers and managers.

And I want to say -- I mean, there are a lot more facts but we -- in the interest of time in terms of how this was, you know, how Cingular was -- was separate, you know. Ms. Biry testified to that yesterday as well. So, I would just refer Your Honors to her testimony yesterday regarding how Cingular was run autonomously -- you know, separately, autonomously, and they had to because of -- of the business they had and the distinct brand that they had.

In terms of legal discussion, I think it is just -- it's very simple really. If you look at Container, for two businesses to be conducting a single

unitary business, they must constitute an integrated economic enterprise. The Court in Container further noted that a -- that the relevant question, unitary business inquiry, is whether contributions to income from functional -- you know, whether there was contributions to income from -- from a functional integration, centralized of management, and economies of scale.

In this case, there was a complete absence of the requisite functional integration and centralization of management or economies of scale between BellSouth and Cingular in 2007 because there are fundamental differences in customers, technologies, employee skill set that prevented any kind of meaningful sharing of expertise or resources. Again, Cingular managed its own day-to-day affairs, made its own major policy decisions. And Cingular continued to have its own administrative functions, even after the AT&T acquisition. It took extended efforts, as Ms. Biry testified yesterday, before any Cingular's administrative functions became integrated with BellSouth or AT&T.

And that's it. Thank you.

JUDGE HOSEY: Thank you.

Franchise Tax Board, are you ready for your presentation? I'll save questions for the end.

MS. MCELHATTON: Okay. That's fine.

JUDGE HOSEY: Okay. Please begin when you're ready. Thank you.

MS. MCELHATTON: Okay.

PRESENTATION ON ISSUE NO. 3

MS. MCELHATTON: Okay. Now we're going to discuss the third issue, which is whether AT&T and Cingular wireless were unitary during 2007. As you may recall, here's the organizational structure before the merger, and then here is the structure after the merger. And then now here is how Appellant filed with three separate combined reports.

Appellant is working hard to confuse the panel by arguing that the issue is whether Cingular was unitary with BellSouth. However, as you can see, Appellant filed three separate combined reports, and Respondent combined both BellSouth and Cingular into AT&T's combined report, not into the BellSouth combined report. So, if we're going to reverse this adjustment for some reason, then the adjustment would be to pull Cingular out of the AT&T combined report.

To refute this argument, we only need to identify the key corporation in the AT&T combined report, which is Pacific Bell Telephone, not BellSouth. This -- this issue has overlapped with the first issue of AT&T and BellSouth

unity. Of course, the reason for the overlap is what I showed you before. AT&T owns 60 percent of Cingular, while BellSouth owned the other 40 percent, and then after the merger, AT&T owned 100 percent of Cingular.

So, part of Cingular was owned by BellSouth and part by AT&T prior to the merger. As a result, BellSouth and AT&T were operating Cingular as a joint venture. The names AT&T Mobility and Cingular refer to the same wireless operation owned by AT&T. So, those names may come up interchangeably. I'll try and use Cingular mostly, though. I'll give a few highlights in this introduction and then I'll go into more detail.

FTB determined that AT&T was unitary with Cingular, and this finding is presumed to be correct. Appellant has the burden of proving by a preponderance of the evidence that it has not -- that it is not correct, and unsupported assertions are not sufficient. Since Appellant has not produced uncontradicted credible competent relevant evidence on this unity issue, FTB's determination must be upheld. Cingular is also presumed unitary with AT&T during 2007 as it was in the same general line of business and was governed by strong centralized management. Both AT&T and Cingular were in the wireless business, and AT&T took over management of Cingular as of the date of the merger. AT&T appointed the

president and CEO of Cingular as of the date of the merger. This supports a finding that AT&T was centrally managing Cingular during 2007.

AT&T reported that after the December 29, 2006, acquisition, Cingular was a wholly owned subsidiary, and its operating results were rolled into those of the AT&T group. Integration of Cingular was planned long before the merger, as we discussed in detail yesterday. Ten months prior to the merger, AT&T representative would be making all decisions for all BellSouth entities, including Cingular. Seven months before the merger, BellSouth reported formation of an integration planning team on its SCC proxy statement. The team included top executives from AT&T, BellSouth, and Cingular. BellSouth delegated all authority for BellSouth matter -- matters, including voting rights to two AT&T executives, shifting control over BellSouth and Cingular to AT&T. As of the merger date, AT&T appointed the president and CEO of wireless operations as Cingular was to be immediately folded in to AT&T Wireless operations.

In addition, AT&T announced executives for the AT&T Wireless segment, which now included Cingular's operations. The announcement was made by the vice president and general manager of AT&T's wireless unit, not by Cingular, which was clearly not acting independently.

Immediately after the merger, Cingular's corporate departments were merged with those of AT&T. As of the merger date, Cingular's financial reporting and workforce data was consolidated. Also, Cingular's insurance policies were canceled as of the date of the merger, and Cingular was added to AT&T's policies.

Within 30 days after the merger, all three of the merged companies could input orders for Cingular services. There was also corporate email enabled for the three companies, and Cingular was also folded into AT&T's security systems in early 2007. The AT&T CTO reported -- and that's chief technology officer -- reported a new CTO organization that consolidated Cingular's chief information office, network services, customer services, and CTO with $1.3 billion of savings from the merger with BellSouth and Cingular. AT&T co-branding and rebranding took place immediately.

Within 60 days after the merger -- premerger, Cingular's IP assets were integrated into AT&T's database. So, there's solid evidence that Cingular was integrated with AT&T during 2007 due to the multitude of cross-selling and bundling of products and services that was occurring and being advertised to the public. Further, AT&T was making announcements of expanded wireless services during 2007 with references to the

former Cingular and to the new AT&T Wireless division. AT&T was upfront through marketing and press releases about the immediate rebranding that took place in early 2007 moving Cingular to the AT&T brand. In this way, AT&T was contributing to Cingular by integrating it into the AT&T corporate structure, co-branding, providing access to AT&T's software, and consolidating operations.

Now, we have the same three presumptions that we discussed in Issue 1. There is first the FTB's determinations are presumed to be correct. And then also the two presumptions from 25120(b), which is from the same general line of business and centralized management. There has not been disagreement about AT&T and Cingular being in the same telecommunications business, and I provided a few of the strong centralized management facts here for your review. I won't go through those. One of the most important facts is that AT&T named the president and CEO of Cingular immediately upon merger. Meanwhile the top BellSouth positions were left vacant.

We have the same test for unity that we had in Issue 1. And then also, we're going to have the same case law that we had on instant unity which includes Appeal of Atlas Hotels. Appellant takes issue with the concept of instant unity between AT&T and Cingular, even though AT&T already owned 60 percent of Cingular prior to the merger,

after which AT&T became the 100 percent owner. With the level of planning carried out prior to the merger, including bundling of services that was already occurring back in 2006 between AT&T and Cingular.

In the many documented areas of integration, there's evidence to support that AT&T and Cingular were contributing to each other and depending upon each other as of the merger date or by the -- no later than January 1st, 2007. On the other hand, the evidence does not support a finding that Cingular was operating independently of AT&T during 2007, which is Appellant's burden to show.

So, briefly we'll go through a few premerger activities. AT&T planned this merger starting 10 months prior to the merger date. AT&T BellSouth were already operating together at the joint venture. There was co-branding and bundling that was already occurring starting in 2006. For centralized departments, Cingular was reported as one of four operating segments of AT&T, and Cingular corporate functions were immediately merged with AT&T's corporate departments. Further facts supporting centralization of departments are seen here that were previously discussed. We have the merging of corporate departments. Also, the Cingular data regarding workforce, revenue, volume, and expense all immediately

input into the AT&T system. In this manner, AT&T was contributing to Cingular by setting up systems so that AT&T could accept data from Cingular.

The centralization of data for reporting purposes occurred early on so that there could be reports including the data from all three companies, which AT&T explained in its press release as provided on this slide. Financial reporting and accounting system consolidation started before the merger in 2006 and finished up during 2007. For human resources, training was combined using AT&T systems, and authority over benefits was transferred to AT&T for Cingular employees. In this way, AT&T was contributing to Cingular by taking over the monitoring of training on a per-employee basis. Cingular insurance policies were canceled and combined with AT&T policies as of the merger date.

For information technology, Cingular personnel were integrated into the AT&T IT organization. Cingular interconnection development, support teams were moved into the AT&T interconnection organization. And AT&T provided its instant messenger platform to Cingular employees, and AT&T contributed to Cingular by including it in its insurance policies. IT operations and IT network architecture were also consolidated. IT operations allowed the three companies to be connected to each other,

allowed all three companies to have access to critical systems, and to have combined internet platforms.

IT network architecture put all three companies on the same IT network during 2007. AT&T contributed to Cingular by consolidating these operations and architecture. Also, for IT, technology standards for Cingular were transitioned to the AT&T standards. Cingular accounts were integrated into AT&T's account system and Cingular's fraud protocol was changed to the enterprise-wide rules and thresholds for monitoring.

Moving from IT to procurement, Cingular supply chain organization was integrated into the AT&T structure. Cross functional teams were used across the companies to reduce supply chain cost. And supplier contracts were renegotiated for quick hit savings during early 2007. AT&T contributed to Cingular by reviewing its supplier contracts and renegotiating for possible savings.

Continuing on with centralized departments and procurement, Cingular supplier contracts were added to the AT&T database. AT&T provided training for Cingular employees on standardized sourcing processes, and many steps were achieved prior to the merger and within the first 30 days, as you can see here. Then other steps were achieved within 60 days after the merger for procurement as listed here.

Moving from procurement to knowledge ventures, much was achieved also during the first 30 days after the merger, including creation of two-way shared networks for the three companies. Also within 60 days, Cingular's intellectual property assets were integrated into the shared AT&T database with all three companies following the same IP policies and using the same invention disclosure systems.

For billing, bundled billing was offered to customers for $2 million per year in saving and $25 million in increased revenue. Also for billing integration, AT&T started migrating Cingular to the public cloud starting before the merger back in 2006. For communication platforms, employees from all three companies were contacted on the day the merger closed and provided with resources to navigate the newly merged operation. A press release was issued externally. A web page was provided to the public, and customer FAQs were posted.

For security systems, systems were shared starting on day one. Architecture and infrastructure were standardized, and security workforce was consolidated. In this way, AT&T contributed to Cingular by standardizing security systems. For security management, the policies of all three companies were combined. Threat management

processes were standardized. Consulting and compliance were moved to a single approach. Security awareness programs were consolidated and the security strategy and solution road map were aligned. For perimeter security, remote access to the system and network based content inspection, the architecture infrastructure and processes were standardized.

Moving on now to executive management. There was extensive premerger planning as was provided during Issue 1. So, I will not repeat all of those. Also, consolidation of management was explained publicly in press releases on the day of the merger. There are numerous press releases from early 2007 with AT&T announcing executives appointed to manage the Cingular wireless business. By June of 2007, Cingular wasn't even mentioned any more.

Moving onto operational consolidation, AT&T explained its areas of focus for integration of Cingular. In this way, AT&T was contributing to Cingular by first co-branding and then rebranding for future use of the AT&T brand instead of the Cingular brand. These areas of focus are in a table on this slide, and the integration goals provided by the AT&T chief operating officer are listed at the bottom. By April of 2007, AT&T was announcing completed integration of cell sights with those of

Cingular.

Synergies were identified between Cingular and AT&T with those listed at the bottom of the slide. Staffing reductions were listed for each of these three areas that benefited from the adjustments where there were overlapping functions performed in both Cingular and AT&T. Forty-three managers from customer care were to be integrated into the network operations plan, or NOP, Mass Market Care Planning. The movement of 43 managers into NOP VP Mass Market Care Planning was to be completed by January 1st, 2007, including a workforce reduction of 7 to executed by the third quarter of 2007. Seventy-eight managers from Cingular's business customer service organization were integrated into NOP V.P. Enterprise Care Planning Organization completed by January 1st, 2007, with eight workforce reductions all executed by the second quarter of 2007. Finally, for the 522 employees in the network services organization, 248 were integrated into the NOP area.

These integration activities illustrate that Cingular was not operating independently of AT&T during 2007. In fact, the first quarter operational results were provided by the AT&T CEO in April of 2007 which focused on positive results from operational changes in the wireless segment. The CEO reported that merger integration is on

track, and that they expanded margins in both wireless and wire line. Mr. Whitacre reported that wireless service revenues increased at a double digit pace. This is April 24th, 2007, AT&T press release. Most important, operational improvements help drive a major step up in wireless margins. Thus, as of April 2007, integration was on track and margins were up.

Now, the CTO summary report provided a wealth of information on integration listing out the savings by different area and the number of positions eliminated. Thus, AT&T contributed to BellSouth and Cingular during 2007 by making the merged operation more efficient. This report provides evidence that there were significant economies of scale during 2007.

Continuing with operational consolidation. There was significant co-branding and rebranding of Cingular to AT&T with Cingular services sold under the AT&T brand, even before the merger, and bundled services offered as early as July 5th, 2006, well before the merger. Continuing on with rebranding, we have press releases going out on the day of the merger. And in January of 2007 announcing rebranding and the legal name change as of the date of the merger. AT&T announced January 1st, 2007, that it was installing AT&T branded media centers in more than 375 formally Cingular wireless stores.

The chairman and CEO of AT&T even announced on January 2nd, 2007, that AT&T could now offer discounts for bundled services that were impossible when Cingular was a separate entity. The fact that AT&T was renaming Cingular immediately after the merger is significant in that it perfectly illustrates Cingular was not operating independently during 2007, as it was immediately swallowed up by its 100 percent owner AT&T. Rebranding was explained in a January 2007 article. I'm not going to read the text to you, but AT&T lays out 2,000 Cingular wireless retail outlets and store kiosks converted to AT&T signage, 1,500 personnel who were changing to AT&T branded apparel, voice greetings that included AT&T name immediately and combined customer billing. This is a January 12, 2007, press release.

If Cingular was independent of AT&T and operating as a stand alone operation, it would not be using AT&T's name. Rather, Cingular stores would keep the Cingular name. Sales personnel would keep their uniforms with the Cingular name rather than switching to wearing the AT&T name. Cingular trucks would not be relabeled with the AT&T name, as there would be no transition over to AT&T signage and advertising. AT&T was contributing to Cingular by moving Cingular to the AT&T brand. Rebranding was discuss in detail in a March 12, 2007, press release

regarding changing the name on Cingular retail stores to AT&T and discussion of the stores carrying AT&T products and services.

Also, in March of 2007, AT&T filed a motion for an injunction against NASCAR because NASCAR was refusing to change the sponsor's name on car No. 31 from Cingular to AT&T. This means that AT&T had moved significantly enough with its rebranding to take legal action when not allowed to change the name on a race car from Cingular to AT&T. The explanation on the legal action came from the AT&T vice president of marketing, not from a Cingular executive. Thus, AT&T was handling the marketing for Cingular in March of 2007 and in this way was contributing to Cingular.

In May of 2007, AT&T prepared to launch the Apple iPhone and kicked its rebranding into high gear. AT&T was to be the exclusive provider for the Apple iPhone and realized that the AT&T brand was well known, and there was no longer a need to co- brand with Cingular, so no longer included the Cingular name. This illustrates that Cingular was not operating independently of AT&T during 2007 but rather, by May, AT&T had completely taken over the branding using only AT&T and not using the Cingular name at all. And the quote here is "AT&T incorporated today announced a new phase of the company's branding

strategy. Overnight AT&T kicked off this phase by replacing the Cingular brand with AT&T on in store signage, store kiosks and point of sale materials in approximately 18,000 combined -- excuse me -- company owned wireless retail stores."

In the same AT&T press release from May 21st, AT&T explained the consolidation of brands and the phasing out of the Cingular brand. Also, in the same May 21st, 2007, press release, AT&T further elaborated that the campaign would now focus on AT&T as a wireless provider. If Cingular was operating independently during 2007, why would the marketing for Cingular wireless services be phasing out the Cingular brand and reliance on the AT&T brand? In fact, why would an AT&T vice president making branding announcements for Cingular wireless services? AT&T was making the marketing decisions for Cingular, and in this way was contributing to Cingular.

Now, moving on to cross selling and bundling. We have an entire list of facts regarding how each of the three companies could sell each other's products and how the system capacity was increased to allow this cross selling. There were workforce reductions with significant savings. Even before the merger occurred, marketing and campaign management project was completed so that the three companies had a linked database application allowing

analysis of incoming data for trends and product performance. There was also a smart selling project that allowed Cingular services to be sold nationwide with upgraded communication services, enhanced software, and additional hardware to support this new market segment.

Continuing on with cross selling and bundling, a single long-distance product set was provided to all customers of the merged company with aligned price plans, fees, and surcharges. AT&T touted the largest un-limiting calling community in America on January 19th, 2007, which included Cingular wireless services that were being offered under the AT&T name. Continuing with the January 19, 2007, press release, AT&T announced that Cingular had created the largest unlimited wireless calling community in America, stating that AT&T was going to capitalize on now having 100 percent control over Cingular by bundling formally Cingular wireless services with AT&T legacy wire line services to create this new AT&T unity plan. This plan included combined billing for both wire line and wireless services. AT&T explained that its strategy was to simplify the process of purchasing and using communication services by combining wireless and wire line services in ways that benefit customers.

Finally, the AT&T chief operating officer touted that in just three weeks since the merger closed, AT&T has

introduced a revolutionary offer. AT&T unity is just the beginning. If Cingular was operating independently from AT&T, there would not be this offering of AT&T Wireless service combined with unlimited AT&T local and long-distance wire line services. Cingular's wireless services were combined with other offerings from the merged company to make this one large offer to AT&T customers as well as Cingular and BellSouth customers.

AT&T was contributing to Cingular by incorporating Cingular's wireless services into a large bundle of services that it referred to as the new AT&T unity plan offered to the combined 100 million customers. On March 8, 2007, AT&T entered into an exclusive content agreement with World Wrestling Entertainment resulting in the largest collection of mobile World Wrestling content to date. However, by March, the Cingular brand was barely even mentioned with AT&T being the focus.

Further, AT&T press releases also focused on the AT&T name in January and April of 2007. By April, the Cingular name was only mentioned one time with all other references to AT&T. This April announcement of AT&T Wireless services shows that the former Cingular wireless offerings were being offered in bundles and labeled as AT&T Wireless services with the focus on business customers. This shows an integration of Cingular and

AT&T, and that AT&T was contributing to Cingular by taking over the marketing of the brand and combining Cingular services with those of AT&T.

In May of 2007, AT&T issued a press release touting its AT&T unified messaging program offered for medium businesses with up to 100 access lines so that they can manage messages through one single electronic mailbox. This was a program that AT&T had back in 2004, but now it incorporated Cingular's services. Thus, AT&T incorporated Cingular service operating -- excuse me -- offerings into its AT&T unified messaging. If Cingular was independent from AT&T, it would not be included in this cross-selling marketing campaign. Again, AT&T was contributing to Cingular by combining Cingular wireless services with AT&T wire line services for a messaging program that offered both services.

Another May 2007 press release informed the public that AT&T had a new web portal that included wireless voice and data services, along with other services. Cingular was not even mentioned at this announcement. This means that Cingular and AT&T were so far integrated by May of 2007 that the Cingular name was no longer being used.

In conclusion, the evidence supports the finding that Cingular was not a discrete enterprise acting

independently -- sorry -- from AT&T during 2007. Instead, through all the operational integration, rebranding, cross selling, and bundling of services, AT&T was contributing to Cingular, and Cingular was depending on AT&T for all the integration project activities which made the combined operation more efficient.

I've summarized some of these points on these three slides that -- and these are the points that we've making. I'm not going to read them all for you. Suffice it to say that the evidence is overwhelming that AT&T took over Cingular, incorporated its wireless services into its own offerings under the name AT&T Mobility to the point where it even stopped using the Cingular name in its announcements. There were strong centralized management by AT&T over the Cingular operation, which was how AT&T contributed to Cingular as of the date of the merger. AT&T was contributing to Cingular by combining operations and making the merged company more efficient. And Cingular was depending on AT&T for marketing and the consolidation of service offerings.

There is sufficient integration for a finding of unity for 2007 and thus, Respondent recommends this panel sustain its finding of unity between AT&T and Cingular.

Thank you.

JUDGE HOSEY: Thank you. Before we go to

rebuttal, the panel has some questions, I think clarifying questions. So, I'm gonna go and do those first. I'm gonna move to Judge Gast.

You have questions for the parties?

JUDGE GAST: Yeah. Yes. Thank you. For -- for taxpayers first, just so I understand the structure here. And it seems like both parties are focusing on different entities for the unity issue here. So, Cingular is a C corporation; is that correct? It's not a partnership.

MS. HUANG: It is a partnership.

JUDGE GAST: It is a part -- so, its tax as a -- classified as a partnership?

MS. HUANG: Yes. I'm looking to Mr. Greibert because he -- he is well aware -- more intimately aware of the fact.

MR. GRIEBERT: Yeah. It was joint ventures [INAUDIBLE].

JUDGE GAST: Okay. So, AT&T owned or indirectly owned 60 percent, and the other 40 percent was indirectly owned by BellSouth?

MS. HUANG: Correct.

JUDGE GAST: Okay. And the issue that you're addressing is the 40 percent interest and whether that the factors and the income flow throw and are combined with --

MS. HUANG: BellSouth.

JUDGE GAST: -- BellSouth. Okay.

And, FTB, you're addressing AT&T's 60 percent interest and whether that is a unitary interest that flows through as well, and it's combined. It's not a separate trade or business?

MS. MCELHATTON: No. We're addressing their 100 percent interest.

JUDGE GAST: Okay for --

MS. MCELHATTON: For 2007, they have 100 percent interest.

JUDGE GAST: Okay. Assuming BellSouth is unitary with AT&T; correct?

MS. MCELHATTON: Correct.

JUDGE GAST: Okay. So, if we determine that BellSouth is unitary with AT&T, then is your position still Cingular not being unitary with that combined group; and I'm saying instantly unitary as of January 1st, 2007? Or is -- if we find instant unity on the first issue, this is a separate issue where the partnership factors and income or loss do not flow through?

MS. MCELHATTON: Correct.

JUDGE GAST: Does my question make sense?

MS. HUANG: Yes.

JUDGE HOSEY: Okay. So, it is a separate issue?

MS. HUANG: In our view.

JUDGE GAST: Okay. But if we find unity on the first issue, then you're just focused on the 40 percent factors, not the 60 percent side of the equation?

MS. HUANG: For this issue, correct. But then as -- as for the first issue, right. The instant unity issue obviously is a separate issue. But for here we are correct that we are looking at BellSouth 40 percent.

JUDGE GAST: 40 percent. Okay. So there's no -- because I thought I saw in your memo that you're not concerned about the 60 percent.

MS. HUANG: Correct.

JUDGE GAST: Okay. All right. That clarifies that for me. Thank you.

MS. HUANG: It's a little confusing here.

JUDGE HOSEY: Judge Lambert, do you have any questions for the parties?

JUDGE LAMBERT: No questions. Thanks.

JUDGE HOSEY: Okay. Let's go ahead and move to rebuttal. I'm sorry.

Ms. Wong, go ahead when you're ready.

MS. HUANG: Thank you Judge Hosey.

REBUTTAL TO ISSUE NO. 3

MS. HUANG: If -- if I may, there's a lot of things to go through here, and it's going to be -- just

keeping in mind Judge Gast's comment yesterday about addressing all of them. I'm going to say up front I will not address all of them. That doesn't mean I agree with all of them, 'cause I don't -- I don't think we have enough time today. But -- but aside from that, and I'm not trying to be flippant. I'm just being honest here. There are a lot of these things I should say up front that I don't know where they come from because a lot of them as Counsel was going through her presentation, I can see -- refer you to Exhibit 47, what Ms. Biry testified to yesterday, as well that it's -- it counters to what was actually happening.

And I saw also two points. The overarching point I'd like to make is Counsel seems to suggest that, if not for the fact that they were unitary, this could not have happened. That is simply not true. Like, Mr. Greibert just said here that this was a joint venture. And as I said in my presentation on this issue is that they did have transactions with each other, right, but they were at arm's length. And they were at arm's length to make sure that they were -- nobody thought one was favored.

So, the fact that there were transactions premerger, you know, you cannot say that oh, if, you know, these were all premerger things that if not for -- not for the, you know, AT&T's control over Cingular, this would

have not have happened. If it was a separate entity it would not have happened. If it operated independently it would not have happened. That is not true.

The second thing is I just want to be very, very clear and -- 'cause this also relates to the first issue is the antitrust laws. The HSR Act that we talked about yesterday. The reason why the HSR Act was in place is to prevent two companies that are proposed to be merged together, while it was going through regulatory review, that they still acted independently because they -- they had to act as competitors. They were required by law. That's what antitrust law is. Every merger -- not every merger proposed goes through. I think we all know that, right.

So, it -- it -- this -- they had to maintain separate entities. They had to operate separately. They could not combine anything, even their interest, their partnership prior to merger close. They couldn't even talk about sensitive customer informations. How could they possibly integrate a business that was separately owned? You know, 40 percent of it was separately owned by completely different public entity. So, I think we all have to keep that in mind that despite what Counsel has said on this issue and the instant unity issue, they were prohibited by law to do any kind integration process, any

kind.

So, any kind of discussion they had had -- you know, high-level general discussion, due diligence, hey, if we get to -- if we actually get to combine you, know, this is our -- we hope to have these savings; the press releases, SCC filings, forward looking, all these things. But what Ms. Biry testified to yesterday was very specific, what actually happened, right. So, if I could very quickly, again, I'm not gonna go through all of them. And -- and I'm only picking the ones that Ms. Biry already talked about 'cause, you know, Counsel said that we didn't show any proof. We certainly did. We showed it with Exhibit 47. We showed it with Ms. Biry's testimony yesterday, which she was here all day for anybody to ask her questions. And so, we definitely have proof.

And in terms of, you know, solid evidence that quote, unquote, that counsel just mentioned, I'm not quite sure. 'Cause like I said, as they were going through all these things. I can't even tell where they're from. But anyway, going forward on page -- again, I understand this is not evidence, but ease of reference, page 99 of their presentation deck. You know, they're talking about, as of merger data of December 29, 2006, Cingular's financial reporting workforce data and all that was combined, you know.

Within 30 days of merger all companies could input orders for Cingular services. That was just simply impossible. What Ms. Biry said yesterday, the systems weren't combined. How could you combine three multibillion-dollar companies in a matter of 30 days with networks like this and systems? So, not to repeat everything that was said yesterday. So that was one example.

And you know, the other thing was on page 103. Here we have human resources database, and that this was done, you know, I assume 'cause there's -- you know, that was done day one of the merger. Day one. I -- I don't know how you could possibly have a database setup day of the merger. It is just physically impossible. And you -- you -- you can -- I mean, these were all the statements being made by Respondent, and I -- I -- I, you know, I -- I'm not sure what else to say other than what Ms. Biry has testified to. All these things are an impossibility.

So, you know, and -- and also for instance, like 10 -- like, page 106, something that Ms. Biry talked about and pointed to, that's also in Exhibit 47, is instant messaging, you know. Respondent put it in here as part of the presentations that that was completed in early 2007. Not true. We also saw in Exhibit 47 that did not -- that did not happen until 2008. Same thing with IT

infrastructure. Same thing with procurement, again Exhibit 47. So, without going through every single one of these as we talked about yesterday, we -- and bundle billing and -- on page 111. These things we all talked about yesterday, Ms. Biry addressed.

And so unless panel has specific questions on -- on those things, I would just ask Your Honors to review Exhibit 47 in detail. A lot of it contradicts what Respondent has here. And once again, Exhibit 47 was prepared contemporaneously in January 2008 by Ms. Biry and her team, which was presented to show the progress of the inter -- of the integration of the companies. So, she was on the ground. She explained what happened, what could not have happened, and so -- and also one last thing. A lot of these things on -- on the slides presented by Counsel here rely on the playbook, and we've already discussed the playbook many, many times. So, I will not spend any more time on that.

But other than that, I think we -- you know, I just want to go back finish up with this is that these were three big companies. All these things that were done, everything that was mentioned that was done could not have been done premerger for all the reasons already mentioned legally. And for three companies to be integrated together took time. And Ms. Biry's testimony,

all the evidence we submitted support that. So, I think I will end it with that, unless the panel has specific questions for us.

JUDGE HOSEY: Okay. Thank you.

Ms. McElhatton, were there any points FTB would like to touch before I ask more --

MS. MCELHATTON: Just one short comment.

JUDGE HOSEY: Go ahead.

REBUTTAL TO ISSUE NO. 3

MS. MCELHATTON: Okay. I would just like to say premerger activities of the combined services is relevant here because it shows AT&T and Cingular were operating together to provide combined services both before and after the merger. The before merger activity show this was already done, so it was easy to do. Even more combined service offerings in 2007; there was AT&T unity plan and the AT&T unified messaging which very clearly included Cingular services.

Thank you.

JUDGE HOSEY: Thank you.

Did you want anything before I go to questions?

MS. HUANG: I'm good.

JUDGE HOSEY: Okay. Just checking. Thank you.

Judge Lambert, do you have any questions for the

parties on Issue 3?

JUDGE LAMBERT: No questions. Thanks.

JUDGE HOSEY: All right. Judge Gast, are there any other questions on Issue 3?

JUDGE GAST: No other questions. Thank you.

JUDGE HOSEY: Okay. I think I'm good as well. It's 11:00 o'clock. Issue 4 is the enterprise zone sales and use tax credits.

MS. MCELHATTON: Yes.

JUDGE HOSEY: Do you want to take a 10-minute break and switch gears, or are we ready to move forward with arguments?

MS. MCELHATTON: We're -- we're ready, but we're fine either way.

MR. VESELY: We're ready now.

JUDGE HOSEY: Okay. Let's do it then. We will begin oral arguments on Issue 4. We will start with Appellant.

You can begin when you're ready.

MR. VESELY: I'll wait for Mr. Riley to get himself settled.

JUDGE HOSEY: I guess I should, for the record, have you introduce yourself on behalf of the Franchise Tax Board.

MR. RILEY: Jason Riley for Franchise Tax Board.

JUDGE HOSEY: Thank you, Mr. Riley.

We'll go ahead with Appellant's oral arguments when you're ready. Thank you.

MR. VESELY: Okay. Thank you, Your Honor.

PRESENTATION ON ISSUE NO. 4

MR. VESELY: Again, in the interest of everybody's time, we've again written quite a bit on this issue. I will briefly summarize our -- our position and -- but then I would then refer the panel to -- to our briefs on this where we go into more depth.

So, very, very briefly on -- on AT&T's California returns for '07 and' 08 -- 2007 and '08, it is the position AT&T properly claimed California enterprise zone use tax credits the EZSUT credits. At audit, the Franchise Tax Board proposed to disallow the credits in full. The auditor asserted that when calculating the credit, the AT&T exceeded the maximum limitation of the EZ sales and use tax credit it could claim in a given year.

The auditor concluded that the maximum amount that the credit could be claimed in a year was based on the taxpayer's total aggregated qualified expenses across all enterprise zones, rather than based on a taxpayer's qualified expenses in each enterprise zone. And we'll call this enterprise zone by enterprise basis, and that

is -- that is the way we think it should have been done, rather than an aggregate basis.

Now, the -- under California -- excuse me. Under California law, the -- the credit limitation, we believe, must be done on a zone-by-zone basis and not across all zones in the aggregate. The California legislature enacted the Enterprise Zone Act, EZA its initials, to stimulate business and industrial growth in economically depressed areas by relaxing regulatory controls that impeded private investment. The Act thus, contain regulatory tax and other incentives that were designed to attract investment into those areas. During the years at issue, section 23612.2(a) provided a credit against the taxpayer's franchise tax liability for sales and use taxes paid or incurred on the purchase of qualified machinery or parts listed in an enterprise zone.

There were two limitations under the Act. They were called the Business Activity Limitation and the Qualified Expense Limitation. So, the business activity limitation is under section 23612.2(f)(1), and it indicated that the amount of credit that otherwise allowed under this section and section 23622.7 that may reduce the tax for the taxable year may not exceed the amount of tax which would be imposed on the taxpayer's business income attributable to the zone determine -- excuse me -- to the

enterprise zone determined as if it was attributable to income represented by all the income the taxpayer had subject to part. So, it was actually a reference to the zone itself.

Section 23612.2(b)(3) define enterprise zone. It's very important to look at all the definitions and all the terminology in -- in this section. And enterprise zone was defined as the area designated as an enterprise zone pursuant to Chapter 12.8. That's of the Government Code. Additionally, in FTB's own instructions for claiming the EZ sales and use tax credit, the FTB indicated that the credit was to be computed on by a zone-by-zone basis. For example, the FTB required that separate business activity limitation per zone and a separate tax calculation form to be completed for the credit, for each zone. So, it's focusing on the zones on a zone-by-zone basis rather than in the aggregate.

The other limitation I -- I mentioned is the qualified expense limitation, and that's 23612.2(b)(2)(B). And that -- that speaks, actually, to the total cost of the qualified property purchased and placed in service of any taxable year that may be taken into account by the taxpayer for purposes of claiming this credit shall not exceed $20 million. In 20 -- 236-- 23612.2(f), the term credit is defined again as the following. The EZ sales

and use tax credit in a particular enterprise zone.

So, there's a theme here. We're looking at the individual enterprise zones. 23612.2(b)(1) provided a special definition for taxpayers. And that means a corporation engaged in a trade or business within an enterprise zone. We're not looking to the general definition of taxpayer in 23037, and it's interesting that the legislature decided to define taxpayer this way. So, when we're looking at, to look at the engaged in a trade or business within an enterprise zone and provides further support in our view to the conclusion that the $20 million expense limitation necessarily applied on a zone-by-zone basis.

There's further support for our position in former section 24356.7. In that particular provision had to do with an election to expense 40 percent of certain property. Now, that -- that section defined property in the past is -- under (c)(1)(B) as purchased in placed in service by the taxpayer for exclusive use in a trade or business conducted within an enterprise zone; again, in a singular. 24356.7(d) also provided again a definition of taxpayer. And it says means, bank, or corporation that conducts a trade or business within an enterprise zone, pursuant to Chapter 12.8 of the Government Code.

Again, it doesn't use the general definition of

taxpayer. As such, when you take a look at this in conjunction with the provisions under 23612, it provides further support that the conclusion for -- that the former section 23612 was intended to be applied on its own by a zone-by-zone basis.

Further -- further support for our position comes in -- in the form of some comments made by the Franchise Tax Board in connection with Assembly Bill 1186. Now, 1186 was in 2007, is when that was introduced. And that initially proposed to add clarifying language to the governing statutory provisions to explicitly state, quote, "The total cost of qualified property for purposes of claiming the credit shall not exceed $20 million per enterprise zone." So, again, per enterprise zone, not entire -- the entire aggregate. No other changes were being proposed.

The FTB stated in -- in an analysis regarding the changed proposed by AB 1186, quote, "This bill would make non-substantive changes to the zone -- enterprise zone sales and use tax credit in Revenue & Taxation Code. This bill would not impact the Department's programs and operations or state income tax revenue." That's the FTB's statement at the time about AB 1186 that it wasn't changing anything. Now, while AB 1186 ultimately was replaced by some unrelated legislation, it's our position

that Respondent's prior statements using the term per enterprise zone language as a non-substantive change to the EZ sales and use tax credit directly contradicts their current position on appeal.

In sum, it's our view that the law is clear that the EZ sales and use tax credit maximum limitation applied to each taxpayer on an enterprise zone by enterprise zone basis.

And that's all I have. Thank you.

JUDGE HOSEY: Thank you.

Franchise Tax Board, are we ready to begin your arguments?

MR. RILEY: I am ready.

JUDGE HOSEY: Okay. Begin when ready. Thank you.

MR. RILEY: Make sure my microphone is in the right spot. Okay.

PRESENTATION ON ISSUE NO. 4

MR. RILEY: Good morning. I'm Jason Riley for the California Franchise Tax Board.

The enterprise zone sales and use tax credit is generated by a taxpayer who pays or incurs sales and use tax on qualified property. For part 10 taxpayers, such as a partnership, that is under R&TC section 17053.70, and

for part 11 taxpayers, such as C corporations, that is under R&TC section 23612.2. Each of these statutes limit the amount of enterprise zone sales and use tax credit on sales tax paid. For a part 10 taxpayer, it's calculated using sales tax paid on up to $1 million of qualified property, while a part 11 taxpayer may calculate a credit for sales tax paid on up to $20 million of qualified property. This is all covered in Respondent's briefing, so I'm gonna focus the oral argument today on part 11. But there is an analogous section in part 10 with the same language, and just that different credit limit.

So, in part 11 section 23 -- 23612.2 subdivision (a) provides a tax credit for the taxable year in an amount equal to the sales or use tax paid or incurred during the taxable year by the taxpayer in connection with the taxpayer's purchase of qualified property. The definition of qualified property includes such things as machinery and machinery parts used for fabricating, processing, assembling, and manufacturing. And the definition of qualified property also requires that the total cost of qualified property purchased and placed in service in any taxable year that may be taken into account by any taxpayer for the purposes of claiming this credit shall not exceed $20 million.

So, for the purposes of this appeal, the key

section here is 23612.2 little (b)2 capped(B). The total cost for the purchases -- for the purposes of claiming this credit shall not exceed $20 million. That is a statutory mandate, and it's pretty clear. The total cost shall not exceed $20 million. Appellant's arguments do not support increasing the limit of $20 million when generating the credit. Appellant's read language into the statute that simply does not exist and was neither contemplated nor implied by the legislature.

When it comes to their analysis, Appellants have applied the wrong legal standard for tax credits. I believe their brief cites to the Appeal of Save Mart, which relates to the manufacturing investment credit; and the -- the legal standard that they apply is that the tax credit should be interpreted liberally. No. Sorry, not tax credits but tax laws. Let me -- let me clarify that. Tax laws should be interpreted liberally in favor of the taxpayer. However, when we're dealing with tax credits, it is well settled with California Supreme Court cases and numerous Office of Tax Appeals precedential opinions that tax credits are a matter of legislative grace, and statutes granting them must be strictly construed against the taxpayer resolving any doubts in favor of the Franchise Tax Board. Where there is no ambiguity, as here, then the California Supreme Court has held that the

legislature is presumed to have meant what it is said -- what it said, and the plain language governs.

Here, the legislature said, look, we're gonna give you a credit, but we are placing a hard limit on that credit. And when you make that credit calculation, that $20 million limit must relate to the payment of sales and use tax that was paid in connection with the purchase of the qualified property. And that total of $20 million can be derived from qualified property purchased in any combination of the State's 42 enterprise zones. The qualified property must be used by the taxpayer exclusively in an enterprise zone, as opposed to outside an enterprise zone. And the qualified property must be purchased and placed in service before the date the enterprise zone designation expires, is no longer binding or becomes inoperative.

So, to -- to address Appellant's argument that an enterprise zone means there shows -- like, it's -- it's -- there are 42 separate credits basically, no. It just means that when the -- when you are talking about the property, you got to work within an enterprise zone. And so, the antecedent basis for the -- the quote, "The date the enterprise zone expires," that comes from subsection cap (C) immediately above where it states, "An enterprise zone." Okay. But when a taxpayer goes about claiming

this credit, the statute clearly states the total cost shall not exceed $20 million. Period.

Now, Appellant's interpretation of the statute would have you believe the legislature had inserted three words into the statute that the statute did not -- that the legislature did not insert into the statute. Appellants want you to believe that the $20 million limit applies to each individual zone. In the taxable years at issue, there were 42 California enterprise zones. And if you have 42 $20 million limits, that math works out to $840 million. Appellants want to limit -- want that limit for each of PacBell Corporation and AT&T Corporation, which amounts to calculating on, you know, in -- in this appeal, calculating the credit on up to $1.68 billion. Appellant's erroneous reading of the word -- of words absent from the statute would obliterate the legislature stated shall not exceed $20 million limit.

If an $840 million limit sounds absurd to you, that is because it is, and it would create an absurd result. And here in California, courts avoid absurd results when interpreting statutes. Appellant's would have OTA interpret away a clear legislature mandate in favor of an ambiguity that does not exist. The legislature set that limit at $20 million. Period. And had it wanted to say a different limit, the legislature

knows how to say so; and here, it did not.

Briefly, I will state that FTB forms and instructions are not an authoritative source of law and do not change the plain meaning of tax statutes, especially here where Appellant's brief cited to the 2016 Enterprise Zone Booklet 3805Z, a booklet in which the enterprise zone sales and use tax credit does not feature, because the enterprise zone sales and use tax credit had been repealed in 2013; and the purchase of qualified property had to have occurred before January 1st, 2014.

Just as importantly, Appellant's out of context quote comes directly from a section in the booklet on apportionment of all enterprise zone credits, rather than being a comment on the calculation of either the enterprise zone sales and use tax credit, or the enterprise zone hiring credit. The enterprise zone sales and use tax credit has already been calculated at this point. Okay. How the various enterprise zone credits are then divvied up does not relate to the generation of the credit prior to appoint -- to apportionment.

And finally, with Appellant's Exhibit 55, Appellant's have made much of a comment on a legislative spot bill, which is just a placeholder for a late substantive bill. And the assembly rules can be -- they won't even refer a spot bill to a policy committee unless

they are substantively amended. The -- in fact, the -- the header of the spot bill cover sheet in question states in all caps, "NO ANALYSIS REQUIRED." There's no analysis required because this thing is not the language of whatever final bill it's going to become. It is not been substantively amended yet and has not been referred to a policy committee.

Here, FTB did not analyze the language because according to the author, Assembly Member Betty Karnette quote, "This bill is a spot bill." Member Karnette was just saving her place on the busy legislative calendar, and she gave FTB every indication that the spot bill was exactly that, a spot in line, and its contents would be stripped and replaced with something like the Private Railroad Car Tax Law bill that it eventually became. FTB performed no analysis of the spot bill, and the legislature's $20 million limit should not be increased to $840 million based on this unchecked and unanalyzed spot bill that never really saw the light of day.

But ultimately, OTA does not enter -- need to entertain Appellant's argument because the statute on claiming the enterprise zone sales and use tax credit is not ambiguous, and we don't interpret away clear language in a statute in favor of an ambiguity that does not exist. Here, the legislature provided a statutory mandate, and

it's clear that for the purposes of claiming the enterprise zone sales and use tax credit, the total cost shall not exceed $20 million, and Respondent's determination should be sustained.

Thank you, and I'm happy to take any questions the panel has.

JUDGE HOSEY: Thank you.

I will move to Appellant's for rebuttal.

MR. VESELY: Yes.

JUDGE HOSEY: Go ahead when you're ready.

MR. VESELY: Thank you, Your Honor.

REBUTTAL ON ISSUE NO. 4

MR. VESELY: I guess I would ask one question of Mr. Riley. Did FTB make the statement to which we referred, that that 1186 was actually, you know, did -- did they make the statement that this bill would make non-substantive changes to the enterprise zone sales and use tax credit in the Revenue & Taxation Code? This bill would not impact the department's programs or operations or state income tax revenue.

I mean, I -- I hate to say I'd love to have my statements read back to me, but that is something they said. I don't care if the bill never passed. They made it. Taxpayers need to rely upon it. And frankly, we have

another issue coming up pretty soon, and that's about penalties. So, we're getting hit with a penalty for this -- this particular credit issue, and that's just wrong.

But the point of it is right here, is that there is ambiguity in the statute. I pointed out terminology there. Anybody can read the words "the," "and," et cetera. And so, I -- I think that's the problem on it. I fully understand what Mr. Riley is saying, and, you know, I respect what he says. I disagree with him.

Thank you.

JUDGE HOSEY: Thank you.

Did you have any rebuttal that you'd like to address?

REBUTTAL ON ISSUE NO. 4

MR. RILEY: So, I think what we're really -- we're really talking about two separate things here. Okay. We're talking about the -- the generation of the sales and use tax credit under section(a), and then we're talking about the aggregation and use of both the hiring credit of the sales and use tax credit under section (f). So, the enterprise zone sales and use tax credit refers to two distinct points in time. There is the generation of the credit, and then later the use. This $20 million

limit applies to the generation of the sales and use tax credit as the claiming of the credit, while section (f) refers to the credit allowed to be used in each enterprise zone and includes both the sales and use tax credit under 23612.2 and the separate hiring credit under 23622.7.

Those two separate credits were aggregated and could be used against the business income attributed to each zone in which a taxpayer operated. Okay. Anything left is -- is would be a carry forward. But I guess the -- you know, the taxpayer's interpretation it -- it begs the question of, if it is indeed 42 separate credits, a credit for each enterprise zone -- which is essentially it has what they're arguing -- then why is there a need for an apportionment statute under section (f)? If it's 42 different credits, then why wouldn't it simply be well, I'm -- I'm taking the -- the Hollywood enterprise zone sales and use tax credit here, and I'm taking the Bakersfield zone enterprise zone sales and use tax credit here.

It -- it really makes no sense if there are 42 separate credits, which is essentially what they are -- what they are arguing. Now, it's -- it's one credit you get. There's a $20 million limit on how you calculate it, and once you calculate it, okay, that part is set. You move on to the apportionment, chop it up for the various

zones in which the taxpayer operates.

Thank you.

JUDGE HOSEY: Thank you. Any final statements before I go to questions from the panel?

REBUTTAL ON ISSUE NO. 4

MR. VESELY: I think the only thing that I would add is that when this whole program was put in, you know, the whole idea was to encourage investments and encourage investments in the various 42 enterprise zones. And I think that, in looking at whether or not an aggregate approach actually satisfies really the legislature's intent back then, I really don't know, to be honest with you. I'm just saying there is some ambiguity here, and I don't think it's quite as clear as Mr. Riley would like it to see.

Thank you.

JUDGE HOSEY: Thank you.

I'm gonna move to the panel for questions.

Judge Lambert, do you have any questions for the parties on Issue 4?

JUDGE LAMBERT: No questions. Thanks.

JUDGE HOSEY: Judge Gast, any questions for the parties on Issue 4?

JUDGE GAST: Yeah, real quickly, I just wanted to

follow up with Mr. Riley on your point about the apportionment. My understanding is the apportionment is to -- you take your California source business income and then you use a two-factor formula and you divvy that up with the EZ, then you compute a tax; and then against that, you apply the credit. So, is it conceivable that you would have a $20 million credit per zone under that?

MR. RILEY: Well, a couple of things. You know, obviously you know my position -- or you've heard my position on that it is a -- a single $20 million limit. I think if you -- if you were to look at the -- the legislative intent behind the -- the credit, right; at the time that this credit was enacted, the Senate Bill 2023 -- that's the bill in which this -- this credit was enacted -- each of the -- the Senate and the assembly bill analyses of this, they state that this credit is going to impact the -- the State's fiscal budget by $41 million total.

Now, if it were as the taxpayers are saying, okay, at -- at the time that this was enacted, there were only 30 -- 30 enterprise zones. Okay. If it's as enacted, and the taxpayer operated in each of those zones and claimed a $20 million credit in each of those zones, that one taxpayer would have generated $48 million in credit. And so, to say that the legislature anticipated,

yes, it's a -- certainly we meant in every zone it's a $20 million limit. I don't think that the -- the legislature in its -- in its wildest dreams would have contemplated that.

JUDGE GAST: Thank you. No further questions.

JUDGE HOSEY: Thank you.

Any other comments from the parties before we move to Issue 5? I think we have a little bit of time, so I think we should get started if there's no objections.

MR. VESELY: No objection.

JUDGE HOSEY: Okay. Thank you.

Let's move to Issue 5, the royalties. We'll go ahead and start with Appellant's oral arguments when -- you can begin when you're ready, Mr. Vesely, or --

MR. VESELY: I'll --

JUDGE HOSEY: You'll -- okay. Go ahead when you're ready. Thank you.

MR. VESELY: Thank you, Your Honor. Excuse me.

PRESENTATION ON ISSUE NO. 5

MR. VESELY: Again, this is another issue that has been briefed, you know, throughout -- throughout all of Appellant's briefs, and Franchise Tax Board has filed their own. It's actually pretty simple the argument and the issues. It's our -- our view is that the plain and

unambiguous language of Regulation 25137-1(f)(3)(B) as in boy, as it read during the tax years in issue, very critical, require the inclusion of the subject royalties in AT&T's sales factor denominator.

The language of that particular provision is -- is important. It said the following, notwithstanding any inner company eliminations described in subparagraph (a) above, sales made to non-partners shall be included in the denominator of the sales factor in on amount equal to such taxpayer's interest in the partnership. Interestingly, the same time subdivision (a) of the same statute or regulation, while during the years in issue, (a) provided that intercompany sales between the taxpayer and the partnership must be eliminated from the California sales factor denominator. There was an exception put into the law -- into the regs by FTB that dash -- 25137-1(f)(3)(B) as in boy, for sales made to -- by the partnership to a non-partner.

That's the way the reg read during the years at issue. The FTB ultimately amended the Regulation in 2018 on a perspective basis and basically removed the subdivision (b) provisions as they read in 2007 and '08. I should add as well, this regulation was around for 20 to 30 years before, and it basically was long -- long -- long hands -- long-term handling here. This reg has been

around.

The FTB is -- has made various arguments. They've raised the Chase Brass case, which is, you know, from tax years 1954 to '56, I think, as I recall in that case. That was under a totally different regime for, you know, apportionment of income in California. It wasn't UDITPA. The FTB has basically tried to disavow the regulation as it's read during the years in issue. And it's our view, it's very simple. They need to follow it. The changes made to that regulation you know in 2018, 10 years after our years, were made perspective specifically. That's fine. The laws changed at that point. Our position is that we got to apply the law as read during this year.

Thank you.

JUDGE HOSEY: Thank you.

We'll go ahead and move to the Franchise Tax Board for your oral arguments on Issue 5. This is 5, right?

MS. MCELHATTON: Yes, we're on 5.

JUDGE HOSEY: Okay. Wow, we zipped through them. Okay. Issue 5.

So you can begin when you're ready. Thank you.

MS. MCELHATTON: Okay. Thank you.

///

PRESENTATION ON ISSUE NO. 5

MS. MCELHATTON: The issue we're addressing can be best understood by looking at a diagram. What you see here on the slide is members of a combined reporting group. In the center in the triangles you see two partnerships. The partnerships have licensed intellectual property to the unitary combined reporting group members in the two bottom squares. Those two bottom squares are not partners of the partnership, but they are combined reporting group members.

As you can see, the two bottom unitary members pay royalties up to the two partnerships, and it's these royalties that are at issue. While Appellant has removed those royalties from the tax base, meaning they are not subject to tax because they are intercompany, Appellant asserts that these receipts should, nevertheless, be included in the sales factor denominator of the group based on a misinterpretation of the language in the regulation. The regulation has since been amended to stop taxpayers from asserting they can include these receipts in their sales factor, even though they are clearly intercompany, and the amounts at issue are not subject to tax.

The regulation at issue is Regulation section 25137-1 subdivision (f) sub-section (3). So,

let's talk about the law for a minute. Regulation section 25137-1 provides the rules for allocation and apportionment of partnership income. It was amended in 1976 to include the language that is at issue today at 25137-1(f)(3)(B). Subdivision (f) provides the rules for the apportionment of partnership income where the partnership's activities and the taxpayer's activities constitute a unitary business under established standards, disregarding ownership requirements. Subsection (f)(3) discusses the sales factor, and I've included the text on this slide.

To summarize, it states that the partnership sales are included in the sales factor to the extent of the taxpayer's interest in the partnership. Intercompany sales between the partnership and the taxpayer are eliminated from the sales factor. Then at subsection upper case (B), there is a language at issue today, which says that sales made to non-partners are included in the taxpayer's sales factor. And it says -- I'll read it to you -- "Notwithstanding any intercompany eliminations described in subparagraph (a) above, sales made to non-partners shall be included in the denominator of the taxpayer's sales factor in an amount equal to such taxpayer's interest in the partnership."

On January 6, 2011, after the years at issue on

appeal, the FTB issued Notice 2011-1 giving FTB's published position on taxpayer's using Regulation 25137-1(f)(3) as a rationale to include intercompany receipts between a partnership and non-partner members of the same combined reporting group in their sales factor, giving eight reasons why these intercompany receipts are excluded from the sales factor. Thus, Appellant has been aware since 2011, 15 years of FTB's position, that inclusion of intercompany receipts in the sales factor is incorrect.

In addition, Regulation 25137-1(f)(3)(A) has since been amended, adding the words "or any member of the taxpayer's combined reporting group" to clarify that these receipts are excluded. So, subdivision upper case (A) now states, "Intercompany sales between the partnership on the one hand and the taxpayer or any member of the taxpayer's combined reporting group on the other hand shall be eliminated from the denominator of the taxpayer or the taxpayer's combined reporting group if applicable, as well as the numerator of the taxpayer's sales factor." This language is repeated through subdivision (f)(3) to make it clear that sales between members of a combined reporting group are excluded from the sales factor.

Appellant owned two partnerships, IP one and IP two we'll call them, and they licensed intellectual

property to other members of the AT&T combined reporting group; and those other members were not members -- excuse me -- not partners of IP one or IP. In other words, these were intercompany transactions between unitary members of the same AT&T combined reporting group. These royalty paying entities were non-partner members of AT&T's combined reporting group. AT&T included these royalty receipts paid by non-partner combined reporting group members in its sales factor for both 2007 and 2008, even though these amounts were eliminated from income subject to tax and were clearly intercompany. Respondent excluded these royalty receipts from AT&T's sales factor for 2007 and 2008, and this is the adjustment that's at issue today.

Appellant's interpretation of the term non-partner is not supported. Appellant argues that Section 25137-1(f)(3) requires that sales made by a partnership to a non-partner are required to be included in the taxpayer's sales factor denominator, even if the two parties are members of the same combined reporting group. There are longstanding corporate intercompany elimination rules that eliminate receipts from transactions between combined reporting group members, and we exclude them from the sales factor. You can see this at Regulation 25106.5-1 subdivision (a)(5). Treatment is

the same when one of the transacting partners is a partnership, but the authority is different. It's Regulation 25137-1-(f).

Appellant's interpretation of the term non-partner is inconsistent with basic combined reporting principals. The reason that the additional language was not originally included in the regulation was because the law was clear regarding elimination of intercompany transaction receipts from the sales factor. The initial statement of reasons for the later regulatory effort that added language to 25137-1 said that because of existing precedential case law, the regulation was not explicit regarding transactions between the partnership and members of the combined reporting group that were not partners. This was remedied for 2019 forward. And for the earlier years, case law dictates the same result.

So, in 1966 California adopted the Uniform Division of Income For Tax Purposes Act, which I'll -- which we all refer to as UDITPA. That's Rev & Tax Code section 25120 through 25139. The combined reporting method of apportionment was upheld in Edison California Stores back -- way back in 1947. For a combined report, the income and factors of all of the members of the group are added together in a series of schedules that are attached to the return, and we refer to those as the

combined report. These schedules are used to apportion income between the jurisdictions.

The California sales factors apply to the total business income of the group to arrive at California taxable income, which is then attributed to each of the taxpayer members of the combined reporting group. The court in Edison held that there's no difference between a parent company with several divisions and a parent company that has separately incorporated subsidiaries, making it clear that the structure of the group doesn't matter. The treatment is the same if all are unitary. The UDITPA rules, including the regulations promulgated by FTB, must be read consistently with the longstanding use of the combined reporting method. Subdivision (f)of Regulation 25137-1 only applies to the apportionment of business income where the partnership's activities and the taxpayer's activities are unitary under established standards disregarding ownership requirements.

Simply put, this regulation states that sales between members of the combined reporting group are eliminated as intercompany transactions. The issue only arises because Appellant wants the word non-partner to include members of the combined reporting group. The plain meaning of non-partner refers to an entity that is not a partner in the partnership. Sales made to a

non-partner non-member are properly included in the sales factor, as this is a sale that is made to third parties that are not members of the combined reporting group. In other words, these are sales made outside the group.

There's no dispute that Appellant, the partnership, and the subsidiaries paying the royalties are all unitary and thus, members of the same combined reporting group. The case law that governs this issue is Chase Brass from 1977. Under that precedential case, no net income is created where the non-partner member making the payment and the recipient are unitary. The Court held while gross sales are used to compute the sales factor, only net income is subject to the franchise tax. Since no net income is produced by the internal sales, it was not required that they be included in the computation. Ordinarily, sales between the members of a combined reporting group are not reflected in the combined reporting group's sales factor because such sales have in economic effect outside of the combined reporting group. And thus, they do not generate income. Since no net income was produced from the internal transactions, the amounts are not included in the sales factor.

If a regulation is ambiguous, then one may look to other resources for clarity. Each sentence must be read not in isolation, but in light of the statutory

scheme. Here, precedential case law and the statutory apportionment rules that apply in the years at issue require intercompany elimination from the sales factor for transactions between members of a combined reporting group. Pursuant to Chase Brass, since no net income is produced by the internal sales, the receipts from the transactions are not included in the sales factor. It's relevant that sales between corporate members of a combined reporting group are eliminated as intercompany transactions.

You can see this at Regulation 25106.5-1 subdivision (a) at (f) cap (A) (1), effective August 12th, 1999, for intercompany transactions occurring on or after January 1st of 2001. And it states sales attributable to intercompany items are not included in as sales factor either in the year of the transaction or in the years in which such intercompany items are taken into account. This treatment was intended to be the same for the partnerships with income and factors included in a combined report. If these intercompany sales were included in the sales factor, it would give rise to apportionment that does not clearly reflect the taxable income of the combined reporting group.

Appellant is not arguing that the income produced from these intercompany transactions should be included in

its apportionable tax base and not eliminated from income as intercompany, rather, it seeks to misinterpret the regulation and include receipts from intercompany transactions that were never intended to be included, while the income from those varied transactions is eliminated from the tax base. That makes the manipulation here plain.

Respondent request that its position that these intercompany royalties be excluded from Appellant's sales factor be sustained on appeal.

Thank you.

JUDGE HOSEY: Thank you.

I'll go ahead and move to Appellant for rebuttal.

MR. VESELY: Thank you, Your Honor.

REBUTTAL ON ISSUE NO. 5

MR. VESELY: I mean, this -- this issue has been astounding to me since we first saw it. This is FTB's own regulation. It was in place for years and years and years, and they are basically saying that not that we don't fall within the regulation, but the fact is the regulation is ambiguous, or it's wrong, or whatever. Yet, it took them until 2018 to actually change it. Yes, they had a notice in 2011 as -- as Counsel indicates, but the fact of the matter is we're looking at 20 -- 2007 and 2008

as tax years.

What was the regulation at that time? Does our -- do our facts support -- fall within that regulation? And our position is very clear, that -- that we followed exactly what the law was at that time. I'm -- our view is FTB cannot disavow this regulation. Simple as that.

Thank you.

JUDGE HOSEY: Thank you. Okay. We'll move to the panel for questions.

Judge Lambert, any questions for the parties on Issue 5?

JUDGE LAMBERT: I have no questions. Thanks.

JUDGE HOSEY: All right. Thank you.

Judge Gast, were there any questions for the parties on Issue 5?

JUDGE GAST: No questions as well. Thank you.

JUDGE HOSEY: Okay. Thank you.

I appreciate your arguments on that. We still haven't hit noon yet. If you want to move to Issue 6 we can, but we can also take our long break now. Whatever you prefer.

Appellant's?

MR. VESELY: Yeah, we're -- we're happy to go forward right now.

JUDGE HOSEY: Okay. Franchise --

MR. VESELY: I mean, let's -- let's keep this moving.

JUDGE HOSEY: Okay. Franchise Tax Board?

MS. MCELHATTON: We're ready.

JUDGE HOSEY: You're ready.

Okay. Then let's please move to Issue 6, the rabbi trust business, non-business income.

I will go ahead and start with Appellant's argument when you're ready.

MR. VESELY: Thank you, Your Honor. Excuse me.

PRESENTATION ON ISSUE NO. 6

MR. VESELY: I'm gonna sound like a broken record, but we have definitely briefed this issue to death already. And frankly, I'm just gonna briefly summarize what our position is here. Excuse me.

The term rabbi trust is an interesting one. It's a form of retirement plan that permits contributions to receive deferred tax treatment so as long as the employee does not receive the economic benefit of the contribution, and the assets remain substantial risk of forfeiture. So, during the years in issue, AT&T maintained a rabbi trust. Under law, it was required to report the rabbi trust interest and capital gain income from investments as --

and they repeated it as non-business income, but they need to, under federal law, reported it as income. Now, you classify what it would be here.

What our -- our view on this is a couple of things that -- that are important here. The -- the funds, once they are contributed into the rabbi trust are not accessible by the AT&T. They are not items -- this is not like an other -- other retirement plans, et cetera. This is not something they can put their hands on. The -- for California purposes, AT&T reported the income from the rabbi trust investments as non-business income. And they did it because of essentially one case that the Board of Equalization handed down back -- I don't know, a number of years ago -- called Consolidated Freeways.

In Consolidated Freeways, the Board of Equalization looked at two criteria for a functional test under -- under the facts of that case. And they -- they said that there was no short-term business made for the funds, and -- and for purposes of the rabbi trust, that's exactly what it is. Once its funds are in there, AT&T had no right to -- to access them at all. They're prohibited from accessing and using the funds to fund their regular operations. That -- that becomes a very critical part of Consolidated Freeways.

The other part of Consolidated Freeways is that

whether the rabbi trust funds were are liquid or not, and whether they were earmarked for a specific future business need. In both instances here, that's not the case here. The funds are there for the employees that when they finally do want to access the funds as part of their retirement plans, they're the ones who can get it, not -- not AT&T.

So, our position, frankly, is -- is relying on Consolidated Freeways, relying on the fact that we're -- we're not talking about something they could access, something that was liquid, whatever they couldn't use in their regular operations. Therefore, the income from that, which they do have to report, we believe those should be non-business income. Thank you.

JUDGE HOSEY: Thank you.

I'll go ahead and move to the Franchise Tax Board for your oral presentation on Issue 6.

MS. MCELHATTON: Six.

JUDGE HOSEY: Yes. Thank you.

MS. MCELHATTON: I know it's hard to keep them --

JUDGE HOSEY: I know. All right. Here we go.

PRESENTATION ON ISSUE NO. 6

MS. MCELHATTON: Okay. Trust funds were made at audit to change the characterization of certain interest

income, about $25 million for 2007, and a little over $16 million for 2008, and capital gain income of almost $50 million for 2008 from non-business to business income. Appellant is arguing for non-business income, and this is adjustment that is at issue today.

So, first I'd like to discuss failure to exhaust administrative remedies. This -- the doctrine of fail -- of exhaustion of administrative remedies requires a party to use all available agency administrative procedures for relief and to proceed to a final decision on the merits by that agency before they may resort to the courts. Appellant argues that this doctrine is not available, unless the case is in the civil court system rather than the administrative system, like we are today. However, the problem here is if Appellant prevail on this issue at the OTA level, Respondent does not have the ability to bring this case before the superior court where it can argue failure to exhaust administrative remedies; hence, we're raising it today.

Appellant's protest letter had one short paragraph on this issue arguing the investments that generated this income were segregated from taxpayer's working capital and should be treated as non-business income under FTB Legal Ruling 98-5. Respondent sought further information on the nature of the rabbi trust

income, the facts, the law, the supporting documents for Appellant's position, company break downs. We -- some partial information was provided, but then after that, Appellant refused to provide any information at protest.

Respondent issued IDR 7-1 and 8-1 at protest. IDR 7-1 sought a company-by-company breakdown of the non-business income reported by PacBell Group for the 2007-year, as well as the facts, law, and supporting documents for Appellant's reporting position on rabbi trust income for 2007 and '08. IDR 8-1 asked Appellant to identify what assets were sold by which entities that gave rise to the nearly $50 million gain for 2008, as well as the facts, law, and supporting documents for Appellant's reporting the gain from the rabbi trust as non-business income for 2008. Respondent did not provide the requested information nor any docket -- supporting documents.

Appellant failed to fulfill its duty to provide information under Rev & Tax Code 19504, and failed in its duty to maintain and make available upon request records needed to determine the correct treatments of items of business or non-business income under Rev & Tax Code 19141.6 subdivision (a). Appellant has failed to exhaust its administrative remedies by not cooperating and answering questions and not providing information and documents in response to those requests. Appellant may

not now unilaterally choose to not comply with request for information and documents and then oppose the conclusions that were drawn from the evidence that was provided.

Further, when a taxpayer fails to produce evidence within its control, this gives rise to a presumption that the evidence is unfavorable to the taxpayer. FTB sought complete information prior to reaching its conclusion, but Appellant stopped providing that information and documents early in the process for this issue. Appellant must produce credible and competent evidence in support of its contentions. FTB's determinations cannot be successfully rebutted when the taxpayer fails to provide credible, competent, and relevant evidence as to the issues in dispute. Unsupported assertions are not sufficient to satisfy Appellant's burden of proof.

So, let's talk about burden of proof. When there is a dispute regarding the characterization of income is either business or non-business income, the default position is business income, unless the party advocating for non-business income treatment clearly establishes that the income is not business income. The determination of Respondent as to the character of income is presumed to be correct, and the Appellant has the burden of proving error. Thus, Appellant must show that the rabbi trust

assets were not acquired, managed, and disposed of as an integral part of Appellant's regular trade or business operation; and also that the income from the rabbi trust assets do not arise from transactions and activity in the regular course of Appellant's trade or business. Appellant has not carried this burden.

Let's talk about investments into pension funds. So, without conceding those prior arguments, I'm going to talk about the substance of the issue. Employers may setup a qualified pension plan for employees where amounts paid into the plan are not immediately taxable to the employees, and amounts that the employer contributes are currently deductible as ordinary and necessary business expenses. That is -- that is not what we have here. Usually, the pension plan is managed but a trust. It takes in the employer contributions, and then maintains the investments, later distributing contributions and earnings to employees.

When the value of the assets in the trust exceed the amount needed for future liabilities, the pension is over funded, and pension reversions have been found to be apportionable income. That is why I am discussing the qualified pension plan because that is what was at issue in Hoechst Celanese from its 2001 case from the California Supreme Court, which is directly on point. The seminal

case is Hoechst Celanese where a pension reversion was found to be apportionable business income, even though the taxpayer did not own the pension property.

What was required -- excuse me -- was that the taxpayer obtain some interest in and control over the property, control or direct the use of the property, and transfer or have the power to transfer control of that property in some manner. Excuse me. The court held that the taxpayer's control and use of the property at issue -- excuse me -- needed to be an integral part of the taxpayer's regular trade or business operations to meet the functional test for business income. Applying the standard to pension reversion income, property maintained and used by a taxpayer to retain and attract employees is integral to the taxpayer's business operations. Thus, the Court found that the pension reversion that came when there was a surplus in the trust was business income. The reason given was because the taxpayer had created the trust for the pension plan to retain current and attract new employees.

Income from this rabbi trust was business income under the functional test. Rabbi trust or grantor trust, meaning that the employer reports the earnings from the trust as income. Rabbi trust is a trust established by an employer to provide a source of funds which may be used to

satisfy the employer's obligation to executives under a non-qualified benefit plan. Key features of a rabbi trust are the assets are maintained in the trust and are subject to the claims of the employer's creditors. Contributions to the trust are not deductible for tax purposes by the employer. However, the employer may deduct the benefit payments distributed to the employees. Income earned by the trust is included in taxable income of the employer.

Now, there is a case that it actually involves a rabbi trust and its MINACT Incorporated versus Director of Revenue. This out-of-state cause is directly on point with the issue before the OTA and thus, is persuasive authority. The Missouri Supreme Court found that the trust income was business income under the functional test. The court found that the employer created the plan and funded the rabbi trust and retain employees, similar to Hoechst Celanese. Appellant asserts that their working capital and ear marketing -- earmarking test have not been satisfied. However, all that is required is that the functional be satisfied. There was no discussion of working capital or earmarking in Hoechst Celanese, as those were not relevant in that case on similar facts.

The cases that use those two doctrines involved liquid pools of funds, which is not what we have in this case. Further, it is nonsensical to argue that the

invested assets were not earmarked for a business purpose when those assets were actually invested for a business purpose of providing retirement to employees. So, earmarking is not relevant when funds have already been used for a business purpose.

And so, what we need to apply here is the functional test that's under Rev & Taxation code 25120 subdivision(a). The first element is acquisition. Here, Appellant acquired the property invested in the rabbi trust to generate business income. It is not required that it owned the property or even that it hold legal title to the property. Appellant created and maintain the trust for the purpose of providing a benefit to its employees. It used its own business income and put that into this trust.

Management, Appellant managed. It directed the use of the rabbi trust. This part of the test merely requires that Appellant have the power to direct the use of the property. Property maintained and used by a taxpayer to retain and attract employees is integral to the taxpayer's business operations. Here, Appellant directed the contributions to be made to the rabbi trust, which were then held in trust and invested for later distribution to employees.

And then the final element of the three is

disposition. Appellant disposed, which means they had to have the power to transfer control of that property in some manner. They disposed of the rabbi trust assets. Under Hoechst Celanese, income from the disposition of property is business income if the property is used in the trade or business of the taxpayer. The California Supreme Court focused on the control and use of the property, rather than legalistic rules regarding property ownership. Appellant argues that AT&T did not have the power to transfer the property held in the rabbi trust. However, Appellant created the rabbi trust taking its own business income and contributing it to the trust; similar to what was done in Hoechst Celanese.

Appellant followed all the rules to create a retirement benefit for its employees and transferred its own income into that trust. In this way, Appellant had the power to transfer the property into the trust, thus, creating a retirement benefit that would help attract and retain employees. Appellant argues that the rabbi trust represents employees' deferred compensation and accumulated return on investments, and that AT&T could not use those assets in its telecommunications business. The rabbi trust in this case should be treated the same as the trust in Hoechst Celanese. Appellant has provided no authority stating that assets held in a rabbi trust are

deferred compensation and accumulated return on investments, such that Hoechst Celanese should not apply.

In addition, there's no requirement that AT&T be able to use the assets held in the rabbi trust for its own regular business before the income from the rabbi trust can be considered business income. The holding on this issue should be the same as it was for the pension reversion in Hoechst Celanese. There the Court held Hoechst's control and use of the pension plan assets contributed materially to its production of business income by improving the efficiency and the quality of its workforce, which in turn generated Hoechst's business income. Thus, the pension plan assets were integral to Hoechst's business operations because these assets were interwoven into and inseparable from Hoechst's employee retention and recruitment efforts, an essential part of any business operation.

Appellants cites to Legal Ruling 98-5, business or non-business income characterization of income generated from liquid investments in excess of current and identified future business needs. This legal ruling addresses whether income from liquid assets in excess of business needs is business income solely because the excess assets are available for business use. The facts on appeal for the rabbi trust issue do not involve liquid

assets. The facts in the legal ruling were that the taxpayer's business generated cash in excess of its current business needs for which the taxpayer had no earmarking for long-term uses or specific non-business uses.

The legal ruling cites to Regulation 25120(c)(3) which states interest income is business income where the intangible with respect to which the interest was received arises out of or was created in the regular course of the taxpayer's trade or business operations, or where the purpose for acquiring and holding the intangibles related to are incidental to such trade or business operations. In the current appeal, the rabbi trust was created in the regular course of AT&T's trade or business operation with the purpose of acquiring and holding the stock in the trust related to the AT&T telecommunications business because this was a retirement benefit that helped attract and retain employees. Pursuant to the legal ruling, unless the taxpayer's management segregated the funds in a way that clearly established, they were not being held for use in the unitary business, the income is business income.

Here, the funds were held in the rabbi trust for a business purpose. Appellant's control and use of the rabbi trust contributed materially to its production of

business income by improving the efficiency and the quality of its workforce, which in turn generated business income for AT&T.

Respondent urges this panel to follow the California Supreme Court decision in Hoechst Celanese and find the income from the rabbi to be business income.

Thank you.

JUDGE HOSEY: Thank you. I'll move to Appellant for rebuttal.

MR. VESELY: Just a few things.

JUDGE HOSEY: Go ahead. Thank you.

REBUTTAL ON ISSUE NO. 6

MR. VESELY: Really, the issue I want to make sure that we're clear on is Franchise Tax Board's argument that there is a failure to exhaust administrative remedies. One, that is a judicial doctrine. It has nothing to do with administrative proceedings like this. So, therefore, I -- I think that's absolutely not correct. But factually, it's also incorrect because as we indicated in, I believe it was Appellant's reply brief, we responded to the information document request at issue, which are IDR 7-1 and 8-1. And our responses included a reference to a prior submission on the issue which provided the factual and legal support for classifying the income as

non-business income. And then we provided -- to further answer that, we have nothing further to provide at this time.

So, there's no question that we -- you know, legally there is no such thing as exhaust of administrative remedies before this panel or the OTA. And second of all, we had no deliberate withholding of anything here. As for the merits of -- of the argument we've laid out what we did in the briefs. And that's our position.

JUDGE HOSEY: Thank you. Any other comments from the Franchise Tax Board?

MS. MCELHATTON: Yes, please.

REBUTTAL ON ISSUE NO. 6

MS. MCELHATTON: I would just like to say that the prior submissions that they refer to from another cycle years ago, and each tax year stands on its own, and they are obligated to provide their documentation for this cycle.

Thank you.

JUDGE HOSEY: Thank you.

Appellant, anything before we go to questions from the panel? Any comments?

MR. VESELY: I have nothing further.

JUDGE HOSEY: I just want to check in with you. Thank you.

Moving onto questions from the panel.

Judge Lambert, any questions for the parties?

JUDGE LAMBERT: No questions. Thanks.

JUDGE HOSEY: Judge Gast, any questions for the parties?

JUDGE GAST: No questions as well. Thank you.

JUDGE HOSEY: I'm good as well.

We have one last issue, the accuracy-related penalty. Did we want to take a short break between now and -- or just more forward and get it done?

Appellant?

MR. VESELY: I would be in favor of getting it done.

JUDGE HOSEY: Okay.

MS. MCELHATTON: I would too.

JUDGE HOSEY: Franchise Tax Board we're good? Okay. Okay. I'm sorry.

MR. VESELY: Just one last -- will we get to close on everything too -- have a closing argument?

JUDGE HOSEY: Yeah. We'll have time and final questions as well.

MR. VESELY: Okay.

JUDGE HOSEY: And that will open to all seven

issues.

MR. VESELY: Fine.

JUDGE HOSEY: Okay.

MR. VESELY: Thank you.

JUDGE HOSEY: Okay. We will start with Issue 7, moving to Appellant's oral arguments.

You can begin when you are ready.

MR. VESELY: Okay. Thank you, Your Honor. Excuse me.

PRESENTATION ON ISSUE NO. 7

MR. VESELY: Again, we have -- this issue has kind of changed over time because of what was still -- still at issue frankly, in the case. The FTB had -- I impose an accuracy-related penalty on tax adjustments related to the R&D credit, the enterprise zone sales and use tax credit, and the Medicare Part D issues. As we discussed at the prehearing conference, the Medicare Part D and research and development credit issues are really no longer at issue here. So, we're really just talking about the enterprise zone, the apportion of the liability attributable to the enterprise zone credits.

It is our position is that we have proven that our positions on -- on this issue was supported by substantial evidence, substantial authority, was

adequately disclosed on returns, and had a reasonable basis which was supported by reasonable cause and good faith. I think that from the standpoint here, it's our view that the ARP on -- it's clear the ARP for the other two issues goes away. We understand that. We're still opposing the fact that's being imposed, with respect to the enterprise zone sales and use tax credit issue that we just recently chatted about.

Our view is that the enterprise zone sales and use tax credit were supported by substantial authority based upon the enterprise zone statutory regime, the specific language of the relevant sections of the Revenue & Tax Code, Respondent's tax forms, and Respondent's statements and conclusions with respect to the Assembly Bill 1186, among other items. Appellant has demonstrated, in our view, that the credits were adequately disclosed on the returns, and that they had a reasonable basis for that position. Finally, Appellant's have proven that they had reasonable cause, good faith for position regarding the enterprise zone sales and use tax credits by making reasonable efforts to ascertain their proper tax liability.

Let's go through a little bit about the substantial authority. For purposes of the ARP, there must -- there may be substantial authority for more than

one position with respect to the -- the same item. In which the case, the proper standard is to look at whether the weight of authorities supporting the treatment is substantial in relation to the weight of the authorities supporting a contrary treatment.

As established in our briefing, and will be discussed early -- was discussed earlier today was respect to the enterprise zone, the -- there is substantial authority supporting Appellant's position that the credit limitation must be applied on a zone-by-zone basis and not the aggregate. The substantial authority, our view is -- is found in numerous places; one, the plain language of the enterprise zone business activity limitation and the qualified expense limitation statutes in the entire enterprise zone statutory regime. The special define term, such as the enterprise zone, and taxpayer, among others. Consistently -- consistency was substantially identical enterprise zone sales and use tax credit limitation calculations.

We also look to Respondent's tax forms and instructions and finally, their statements with respect to Assembly Bill 1986 -- or 1186 -- excuse me. In attempt to find -- to support its position, Respondent's argues that section 23612.2(b)(2)(B)-(D) requires all enterprise zones to be treated as a single zone for expense limitation

purposes. However, in making this argument, Respondent ignores the fact that a zone-by-zone approach is used for every other limitation in the enterprise zone statute.

In addition, there is no regulation or case law supporting Respondent's contrary position about the aggregate approach. Taken together, the weight of authority supporting Appellant's position is substantial in relation to the weight of authorities, which Respondents relies upon.

Second, the Appellant's California enterprise zone sales and use tax credit calculations were adequately disclosed on the returns. As noted in our briefs, we disclosed the position regarding enterprise zone credits on the returns by providing, quote, "Sufficient information to enable Respondent to identify potential controversy involved," and that's what's required. In short, the Respondent was on notice that -- that the controversy relating to expense limitation calculation.

In addition, it's our position for the same authorities that I have just mentioned and the plain reading of the statutes, the authorities discussed above provide support that Appellant's had a reasonable cause -- reasonable basis for their position, which is also part of the standard for the -- looking at it under IRC 6662 and R&TC 19164.

Finally, Appellant's efforts to ascertain their property tax liability were reasonable and conducted in good faith. There's no question that Appellant's efforts to ascertain their proper tax liability with respect to enterprise zone tax credits -- sales and use tax credits -- excuse me -- was reasonable, and that they acted in good faith. Here, Appellants employed qualified tax professionals and certified public accountants to assist with Appellant's compliance obligation in hundreds of jurisdictions, all due within the same time period.

The reasonableness of Appellant's efforts is confirmed by Respondent's acknowledgment that Appellants were, quote, "Experienced and knowledgeable taxpayers," unquote. That was the nicest compliment we got from them during this case.

In sum, Respondent's imposition on the ARP on tax adjustments related to the enterprise zone sales and use tax credits is plainly erroneousness under any of these grounds and must be reversed.

Thank you.

JUDGE HOSEY: Thank you.

Move to Franchise Tax Board.

Can I have you introduce yourself for the record please. Thank you.

MR. CRISTOBAL: Yes, of course. Good

afternoon -- or not good, afternoon, maybe almost. My name is Leo Cristobal, and I also represent Respondent Franchise Tax Board.

JUDGE HOSEY: Thank you. You can begin your presentation when you're ready, Mr. Cristobal.

MR. CRISTOBAL: Thank you.

PRESENTATION ON ISSUE NO. 7

MR. CRISTOBAL: Good morning or afternoon. My name is Leo Cristobal, and I represent Respondent Franchise Tax Board.

The issue I am addressing is whether Appellant has met its burden of proof to establish that the accuracy-related penalty, otherwise known as the ARP, should be abated for the tax years at issue. And ARP is imposed and determined under Revenue & Taxation Code section 19164, which generally conforms to the provisions of Internal Revenue Code section 6662. FTB must impose a 20 percent ARP on an underpayment attributable to a substantial understatement of income tax. An understatement means the excess of the amount of the tax required to be shown on the return over the amount of the tax which is shown on the return. And for corporations, there is a substantial understatement if the amount of that understatement exceeds the lesser of 10 percent of

the tax required to be shown on the return or $5 million.

The ARP will be reduced or abated to the extent that there is a valid defense to the ARP. A valid defense applies if the taxpayer sufficiently demonstrates that either; one, there is substantial authority for the reporting position; two, their position was adequately disclosed, and there is a reasonable basis for their position; or three, they had reasonable cause for and acted in good faith with respect to the understatement. In this case adds it relates to the calculation of the ARP, the adjustments at issue are one, Medicare Part D subsidies; two, the California research and development credit or research credit; and three, the enterprise zone sales and use tax credit.

For the Medicare Part D subsidies as it relates to the ARP, FTB's position is that the final Medicare Part D adjustments will be included in the calculation of Appellant's understatement and factored into the ARP calculation. And for the research -- similarly for the research credit, the amount of allowed research credits will not be factored in to the ARP calculation. However, FTB maintains its position that the amount of disallowed research credits will be included in the calculation of Appellant's understatement and will be factored into the ARP calculation.

Finally, for the sales and use tax credit, in order to abate or reduce the amount of the ARP attributable to the sales and use tax credits claimed by Appellant and disallowed by FTB, Appellant would need to sufficiently demonstrate the applicability of a valid defense to the ARP, as was stated previously.

So, number one, as it relates to the defense of substantial authority, this defense requires that the weight of authority supporting the tax treatment be substantial. Treasury Regulation section 1.6662-4 subdivision (d)(3)(I) provides that this is an objective standard, which means the taxpayers belief that substantial authority exists is not relevant in determining whether there is substantial authority. Here, the central authority at issue is Revenue & Taxation Code section 23612.2. And as we've heard, the plain language of subdivision (b)(2) cap (B) limits the total cost of qualified property to $20 million.

As explained earlier in FTB's presentation of Issue No. 4, notwithstanding attempts to create an ambiguity where there is none, the statute's $20 million limit is clear. Ultimately, the imposition of the ARP is appropriate because this issue is not novel, and there is nothing unclear about the application of the statute. Moreover, reliable settled authority supports the standard

for handling disputes regarding statutes involving tax credits and the rules of statutory construction, including California Supreme Court cases which hold that where language is clear, there is no ambiguity to untangle, and that, you know, those cases stand for the proposition that tax credits are a matter of legislative grace, and statutes granting taxes exemptions must be strictly construed against the taxpayer resolving any doubts in favor of the FTB.

Appellant has not demonstrated that the weight of authorities supporting their position is substantial. Accordingly, Appellant has not carried its burden of proof to demonstrate the defense of substantial authority and therefore, this ARP defense fails.

Number two, as it relates to the defense of adequate disclosure with a reasonable basis, Treasury Regulation section 1.6662-4 subdivisions (e) and (f) provide that the -- that this defense applies when the taxpayer discloses their position on a properly completed form attached to the return, Form 8275 or Form 8257-R, and the position must also have a reasonable basis, be properly substantiated, and adequate books and records with respect to the item or position must also be kept. Here, there is no indication Appellant submitted the aforementioned forms 8275 or 8275-R.

Moreover, Appellant's position does not have a reasonable basis. Treasury Regulation section 1.6662-3 subdivision (b)(3) provides that the reasonable basis standard is a relatively high standard that is not met by a return position that is merely arguable or that is merely a colorable claim. Here, Appellant may have made a colorable claim. However, it has not provided substantiation showing how it based its position on its own analysis or an opinion provided by a professional tax adviser; nor has it provided adequate books and records with respect to its position. Ultimately, Appellant has not carried its burden of proof to demonstrate that their position was adequately disclosed and that there was a reasonable basis for that position and therefore, this ARP defense also fails.

Finally, as it relates to the defense of reasonable cause and good faith, Treasury Regulation section 1.6664-4 subdivision (b)(1) provides that a determination of whether a taxpayer acted with reasonable cause and good faith is made on a case-by-case basis and pertinent are the taxpayer's efforts to assess the proper tax -- proper tax liability, the taxpayer's knowledge and experience, and the extent to which the taxpayer relied on the advice of a tax professional. As it relates to reliance on a professional tax adviser, the same Treasury

Regulation subsection (c)(1) provides that the advice must not be based on unreasonable, factual, or legal assumptions and must not unreasonably rely on representation, statements, findings, or agreements of the taxpayer or any other person.

Here, Appellant has asserted it relied on an attorney opinion. However, as discussed throughout the course of this appeal as it relates to the sales and use tax credit, FTB's position is that the advice on which Appellant relied was largely based on unreasonable assumptions. Moreover, Appellant has not met its burden of proof to demonstrate to the extent to which it relied on the advice of a tax professional. For example, a written opinion from a tax attorney specifically advising Appellant that it should take a $20 million limit per zone position regarding the sales and use tax credit.

In light of all the facts and circumstances, including the aforementioned experience, knowledge, and education of the -- of this corporate taxpayer, the position taken by Appellant was unreasonable. Consequently, Appellant has not carried its burden of proof to demonstrate that it had reasonable cause, and this ARP defense also fails.

In conclusion, as it relates to the first two items, the Medicare Part D subsidies and the research

credit, notwithstanding the fact that the primary issues related to those items have been resolved, FTB's position is that these remaining adjustments are also factored into the ARP calculation. And as it relates to the income adjustment caused by the disallowed amount of the sales and use tax credit, Appellant has not met its burden of proof to establish a valid defense to the resulting ARP that must be imposed under Revenue & Taxation Code section 19164.

Accordingly, the calculation of the ARP will include the full amount of sales and use tax credits disallowed by FTB, as well as the finalized amount of disallowed research credits and adjustments related to Medicare Part D subsidies, and FTB's action assessing this ARP should be sustained.

Thank you and happy to address any questions that the panel may have.

JUDGE HOSEY: Thank you.

I'll go ahead and move to Appellant for rebuttal.

MR. VESELY: Yes thank you, Your Honor. Can I -- do you want to speak?

MS. HUANG: Yes.

MR. VESELY: Okay. MS. HUANG: Sorry we got more.

///

REBUTTAL ON ISSUE NO. 7

MR. VESELY: Okay. Let's clarify a few things here. The ARP was being imposed upon three things; the R&D credit, the Medicare Part D, and also the enterprise zone sales and use tax credit. As I believe Your Honor will remember at the prehearing conference there was discussions of the research and development credit. Indeed, Mr. Greibert who was on that call is in the courtroom today to tell you where the status is of that.

And according to our calculations of what is happening, is we're going to be getting 95 percent of the credit that we claimed. And so, I -- it's not a matter about substantial authority in the -- is the amount of substantial understatement. That has to be factored into the analysis of the penalty issue itself. I'm not sure that FTB has actually explained that very well of how they're getting there on the Medicare Part D issue -- and I hope I get this right, Mr. Greibert.

This is very confusing issue about what was claimed, and what was allowed, and what is now the final result, and I think that -- if I got this right -- and could I have Mr. Greibert explain?

JUDGE HOSEY: Yes. You can come up and just introduce yourself for the record and what role you play with the Appellant and whatever questions we're trying to

clarify. Yeah.

MR. GRIEBERT: Yes. My name is John Greibert. I'm a director in the state income group for AT&T. And --

JUDGE HOSEY: Thank you.

MR. GRIEBERT: Medicare Part D issue is where one federal governments subsidizes Medicare cost to AT&T. That income is not subject to federal tax, but it is for California purposes. We don't argue that fact. We did not include $30 million of expense in that --

JUDGE HOSEY: Oh, I'm sorry. Could you move a little closer to the microphone?

MR. GRIEBERT: Sorry. -- 2007 tax year. We had erroneously said we received $93 million from the federal government, and on audit we tried to explain that to the auditors that it was erroneous; it will come out in the federal audit. And that is what is being corrected currently on the review of the 2007 RAR for the Medicare Part D issue. So, the adjustment that will ultimately result is $30 million, not $93 million that was adjusted on audit. It's confusing 'cause --

JUDGE HOSEY: Yeah. And my understanding was that this was agreed to through audit at FTB, and so we're just talking about the adjustment -- go ahead.

MR. GRIEBERT: For -- on the federal audit we had -- we had an affirmative issue saying we claimed

$93 million of Medicare Part D income. So, we excluded that from federal income. But on an affirmative issue for -- on the IRS audit we said we goofed. It was only $30 million. So, there's a $63 million affirmative issue for federal purposes. That $63 million should not be then included in California income.

JUDGE HOSEY: Okay. I understand.

MR. GRIEBERT: Yeah.

JUDGE HOSEY: And as to the accuracy-related penalty, it's the portion that is being disputed, the smaller portion? Do we know Franchise Tax Board what the portion that is applicable to --

MS. MCELHATTON: I believe -- I believe --

JUDGE HOSEY: -- accuracy-related penalty.

MS. MCELHATTON: -- that's already been agreed to. That's why we dropped the issue. And all that Leo was saying is that whatever we agreed to, that's going to calculate down into the ARP. That's all he was saying. We weren't trying to argue the Medicare Part D issue.

JUDGE HOSEY: Okay. So, that -- I think I understand. They're still crunching those numbers, and they're gonna agree to whatever that is. Okay.

MR. VESELY: That -- that is fine with us. We wanted to make sure we got the number right --

JUDGE HOSEY: Okay.

MR. VESELY: -- on that.

JUDGE HOSEY: Okay.

MR. VESELY: So --

JUDGE HOSEY: Thank you.

MR. VESELY: That's really on the numbers. The only other thing I have, and I've already talked about the enterprise zone sales and use tax credit, I respectfully disagree with Counsel for that issue about that we do not meet the criteria of any of the exceptions there to that. But again, I think we start with what number is really the substantial -- is it substantial or not that we've got for the enterprise zone as well. But I do believe that the issues about substantial authority. I won't belabor it. We've already talked about this.

Substantial authority is obviously a higher standard than reasonable basis. I can't recall if it's 50 percent for reasonable basis and 70 for substantial, something like that. But again, I think that the question is about the adequate disclosure. I think we've -- we've hit that as well. So, I mean, I think we've satisfied the requirements for the exceptions, but we got to get the numbers straight too like that.

JUDGE HOSEY: Okay.

MR. VESELY: Thank you.

JUDGE HOSEY: Thank you for clarifying.

Let me see if there any questions from the panel.

Starting with Judge Lambert, any questions on Issue 7?

JUDGE LAMBERT: No questions. Thanks.

JUDGE HOSEY: Thank you.

Judge Gast, any questions for Issue 7.

JUDGE GAST: No questions as well. Thank you.

JUDGE HOSEY: Okay. It is 12:30. Do we want to -- we can have a short break and come back and do final closing statements and then questions, or we can take a longer break. It'll go further into the day. I am happy to accommodate whatever the parties would prefer, starting with Appellant or Franchise Tax Board. Whatever.

MS. MCELHATTON: We're fine with just a short break. I do need a short break.

JUDGE HOSEY: Yes.

MS. MCELHATTON: But we're fine with --

JUDGE HOSEY: We're definitely breaking --

MS. MCELHATTON: We're fine with proceeding.

JUDGE HOSEY: -- 10 or 15 minutes or a longer break.

MS. MCELHATTON: Or just 10 is fine.

JUDGE HOSEY: Ten is fine? Okay.

Appellant's?

MR. VESELY: Ten sounds perfect.

JUDGE HOSEY: All right. Let's take a 10-minute break. We will return at 12:44, and we are now off the record. Thank you.

(There is a pause in the proceedings.)

JUDGE HOSEY: We are now back on the record in the Appeal of Pacific Bell Telephone Company.

We're beginning closing arguments with -- starting with Appellant.

MS. HUANG: Thank you, Judge Hosey. If I may start first.

JUDGE HOSEY: Thank you.

MS. HUANG: I know we are -- I'm actually gonna -- in the interest of time, I'm actually gonna use my allotted time on just the instant unity issue before turning over to Mr. Vesely. Okay.

CLOSING STATEMENT

MS. HUANG: It is important to reiterate that the only date to the instant unity issue on this appeal is January 1st, 2007. The date Respondent has repeatedly argued as the date that AT&T and BellSouth became instantly unitary. It is also important to reiterate again, that we are talking about the merger of two massive telecommunication companies. AT&T had -- had operating revenues of over $43 billion, and BellSouth had revenues

over $20 billion. AT&T had over $145 billion in assets and about 190,000 employees. BellSouth had $57 billion in assets, and 63,000 employees.

Why am I emphasizing the size of these companies? It's because, as Mr. Vesely stated yesterday, there is no case law finding instant unity for companies of this size and complexity. Respondent argues that Atlas and Dr. Pepper are supportive of their position, but the facts of those cases indicate otherwise. First, it is essential for us to keep in mind, again, the sheer size of the AT&T and BellSouth merger. In Atlas Picnic 'N Chicken, P 'N C, operated 20 fast-food restaurants in Southern California. It was on the verge of bankruptcy when it was acquired by Atlas Hotels. Immediately upon acquisition, Atlas CEO and president began to run P 'N C's day-to-day operations. In fact, he moved into P 'N C's business -- offices and spent substantially all his time there. Atlas also substantially changed P 'N C's business by changing its menu and installed seating for eat-in dining versus P 'N C's original take-out only concept.

Also, quite importantly, the BOE found that many of the managerial and operational changes were in the planning stages well before the actual acquisition, and the implementation of those changes happened soon after acquisition. As discussed yesterday, the HSR Act

prohibited -- prohibited any kind of integration planning prior to merger and close. Ms. Biry testified that AT&T and BellSouth were not able to do integration planning premerger. In fact, every premerger meeting she had with BellSouth people, antitrust counsel was present from both companies to ensure there were no antitrust violations.

Ms. Biry also testified that they were legally prohibited from discussing forecast, future plans, employees, compensation, contracts, marketing plans or any non-public confidential or sensitive information that would be required to integrate two companies this size. This was to ensure that the HSR Act was really to ensure that the two companies remained truly independent while the government reviews the proposal -- the proposed merger deal. And in this case, the FCC took over 10 months to review and grant its approval.

A little bit of history. The HSR Act was signed into law in September 1976. The acquisition in Atlas happened in July 1976. Furthermore, even today, the Atlas acquisition would not have been subject to the HSR Act as the law has a threshold requirement of $133 million before it is applicable. The reason I'm discussing this is to show not only was the deal in Atlas minuscule in comparison to the AT&T and BellSouth deal, but that the companies in Atlas were not prohibited by law to freely

plan pre-acquisition for the immediate implementation of the various operational changes post-acquisition. In contrast, in this case of AT&T and BellSouth, they were legally prohibited from any integration planning.

Also, Respondent relies heavily on the merger Playbook for its -- I want to say alleged facts. However, as Ms. Biry testified, the Playbook was aspirational and one-sided. It was prepared with their own assumptions that were based on their industry knowledge and publicly available information. Ms. Biry also testified that as soon as the merger closed and that they were able to share the Playbooks with the south -- BellSouth employees, the Playbook became irrelevant as the BellSouth team came up with their own operational plans with realistic timelines, projected savings, and technical capabilities.

Respondent concedes in writing, in its Multistate Audit Technique Manual section 3090 that, quote, "When a corporation acquires another corporation, a period of time often elapses before enough ties are established between the activities to constitute unity," end quote. Respondent further stated that for instant unity to occur, quote "The new subsidiary must be integrated with its parent immediately upon acquisition, and integration must have been planned or commenced well before the actual acquisition date," end quote.

Although, we agree with Respondent that its manual is not law and is not binding on the OTA, Respondent cannot disavow its own interpretation of the law when advising its own auditors on how they should proceed in a unitary audit just because in this case it supports Appellant's position.

Respondent also discusses Dr. Pepper and tried to compare it to the facts in this case. Dr. Pepper involved a vertically integrated -- oh, vertically integrated companies. Several times in the opinion, the BOE stressed that the two companies were vertically integrated and held that, once there was unity of ownership, they were unitary. This is not the case here. Also, the -- in its argument yesterday, Respondent discussed the Signal Companies -- the Appeal of Signal Companies. In that case, the taxpayer argued that they were instantly unitary on the day they acquired majority of the outstanding stock of UOP. The acquisition date was May 1st, 1975. Taxpayers used several facts post-acquisition, facts that suggest the operational integration to show that they were instantly unitary on the date of acquisition. Yet, the FTB and the BOE agreed he disagreed.

The FTB argued in that -- in the Signal Companies that the parties were not unitary until January 1st, 1976. However, the taxpayer argued that if they were not unitary

on the date of acquisition, which was May 1st, 1975, then they were unitary at least by the first quarter of 1975. The BOE agreed and held that they were unitary on the first date of the last quarter, which is October 1st, 1975. The -- the reason is because they thought -- you know, the taxpayer argued and that BOE agreed that they were unitary as of that date because, quote, "There was no real difference in integrating ties between Appellant and UOP at that date, October 1st, 1975, and at January 1st, 1976, when FTB concedes that unity existed.

So, in the Signal Companies, it is clear that despite the taxpayer looking to facts beyond acquisition date to support instant unity on the date of acquisition, neither the FTB nor the BOE agreed that those facts could be applied retroactively to support instant unity on the date of acquisition. And yet, in this case, FTB is arguing the opposite. But in -- as I said, the FTB is arguing that instant unity happened on January 1, 2007. As Ms. Biry testified, it was impossible to approximate integrate two companies of this size and complexity on day one or even year one. Also, as Exhibit 47 shows, even the most fundamental projects in terms of communication between the two companies, like instant messaging, did not happen until 3/31/08.

Ms. Biry also testified that she did not even

have visibility into who the employers -- employees were at BellSouth until payroll system was integrated, and that was not completed until 1/31/2008. And customer matching, which was a necessary prerequisite for single billing, did not happen until 2/20/2008. After that, single billing was expected to take place in June of 2008. But as Exhibit 47 shows, even that was in jeopardy. So, Exhibit 47 shows how the projects that needed to -- needed on the systems side did not occur until 2008, and that network -- network projects took even longer in some instances. That's why we would ask Your Honors to spend time to review Exhibit 48, which counters Respondent's alleged facts.

As Ms. Biry testified, this was a document prepared by her and her team to show the progress of the integration process, and that was prepared on January 25th, 2008, 13 months after the acquisition date. Ms. Biry's testimony does demonstrate that integration between the AT&T and BellSouth was impossible on day 1 or year 1. She also testified that BellSouth operated independently subsequent to the merger for all the reasons she stated. As you may recall, one of the examples she gave was the large unionized workforce. The employees of AT&T and BellSouth were with different unions and even within AT&T and BellSouth themselves, they had different

unions for different jobs. Ms. Biry gave an example that even after the merger, if a customer had an issue -- sometimes they had to roll out both trucks, two trucks. A truck with an AT&T logo and another truck with the BellSouth logo.

Ms. Biry also testified that BellSouth was very profitable. In fact in Exhibit 2, it shows that BellSouth had over $3 billion in net revenue -- or net income -- pardon me -- in net income as of the end of 2005. So, BellSouth did not need AT&T's funds to operate. As Ms. Biry testified, as such, the daily funding referenced by Respondent in its arguments is that it's essentially cash management system, which the tentacle court did not find to be a unitary tie.

Lastly, I want -- I want to address all the facts that Respondent put out. There's just too many of them for us to address, like I mentioned yesterday, and it is also unclear where some of the facts come from. For instance, Respondent argued yesterday and actually today as well that they were 22 consolidation Cingular projects completed in 2007. We don't know where that's from, but given Ms. Biry's testimony, we understand this to be an impossibility. We cannot otherwise address it because like I said, we don't know where -- where that statement is from.

Another example is Respondent contending that AT&T took over the BellSouth Southeastern region. But again, provides no support -- no evidence to support it. Ms. Biry testified that BellSouth was in charge, not only of its own southeast region but their entire operations because the systems weren't integrated, the people weren't integrated, the networks weren't integrated. They weren't -- they weren't integrated in 2007. Yes, the integration begin. We're not arguing it did not begin, but nothing was integrated enough for them to operate as one.

In contrast, Appellant has provided an overwhelming amount of evidence through its documentary evidence and Ms. Biry's testimony that AT&T and BellSouth were not and could not be unitary on January 1, 2007, three days after the merger closed over the holidays or at any time in 2007.

Thank you. And now I'll turn it over to Mr. Vesely.

MR. VESELY: Thank you. I will discuss now the non-business dividend issue with the Mexican investees. I -- I believe that we have sufficiently shown that the 2011 decision by the Board of Equalization, where they decided the precise issue involved in this case and actually involved Telmex is one of the seven entities in

question, is not just something you discard. There was a full analysis of this there -- that I wish there would have been a full formal written opinion. That would be nice to see. I have read the transcript of the arguments there. I have read other things, and I think that the analysis there is very relevant for what we're talking about today. Excuse me.

Even more relevant, perhaps, is the closing agreement that was entered into from 2003 through 2007. Well, we certainly recognize every tax year stands on its own. That's -- that's Hornbook Law here. The fact of the matter is that closing agreement did and conclude, among other things in it, that Telmex and America Móvil, dividends from those entities are non-business income wholly allocatable to the commercial domicile of AT&T in Texas. We then all of a sudden have in 2007 and '08, our years in question, the Franchise Tax Board has changed its position. Really, ask the question of what changed frankly, and I don't know that has been sufficiently shown.

And I think that the analysis that needs to be taken here, and we've -- we have referred to it over and over and over again because the Hoechst Celanese case is kind of a key here. The language of Hoechst Celanese and the court in Hoechst Celanese about what is required under

the functional test. I -- I don't know that you can put it better than that. There's a closeness here that the Court described that is way more than just merely owning the stock in another company and getting dividends. It can't be that. That's not the analysis. You know, it can't be oh, there's a purpose -- a business purpose for -- for acquiring the stock or whatever. That -- you know, ASARCO.

Said that doesn't fly. It can't be part of an overall, you know, plan to grow the company, and I'm gonna make investments all over the place, and that all of a sudden turns those dividends into somehow, you know, business income. There's got to be something more. And it's that something more that's missing in this case. As I said, the phrase -- the sum of the terms are so critical that they bear repeating one more time. And I promise this will be the last time. The integrally related to the unitary business operations, the stock, needs to be. And that integral as -- as Hoechst Celanese Court said, is really the -- they call it the touchstone for determining whether the property, the shares of stock, has a close enough relationship to the taxpayer and the taxpayer's unitary business to satisfy the functional test.

The Court also went onto say let's talk more about integral means. And they said it really requires an

organic unity. And that's kind of interesting given what FTB wants to argue here. They don't want to get near the word unitary here at all. And I'm saying we have to have a unitary relationship for purpose of combined reporting, you know, to -- to get to the point of business income here. No, that's not the point.

The point is those are some of the criteria the U.S. Supreme Court has been looking at, the factors of profitability that they've referenced in Mobile and Woolworth and ASARCO and Allied Signal; functional integration, economies of scale, centralized management. None of those exist here. None of those exist. So, when you talk about in Hoechst Celanese that there's an organic unity between the shares of stock and the business activities of the dividend payee that contribute materially to the taxpayer's production of business income. So, we got big words, contributes materially, organic unity, integral. One more time, all those words they're very critical in our analysis in this case.

And I -- I think the Court's next statement is the one that I love the best, and I -- I couldn't agree with Judge Johnson more. You really look at Hoechst Celanese and you find these words all over it. It says the property must be interwoven into the fabric of the taxpayer's business operation so that it becomes

indivisible and are inseparable to each other. The flows of value must go both ways in such that the property, the shares of stock, contribute materially to the taxpayer's production of business income.

That does not mean that you get big dividends, and all of a sudden they got to be business income. That's just not the test. Otherwise, everybody who invest is gonna have business income, and that's obviously not what the law provides here. It's the stock. What did the stock do? What did it open doors for you in doing? Did you get price breaks? Did you get preferential treatment? Did you get a good source of supply? Did you get -- did you attract employees? Did you -- did you keep employees? That's what that this intangible needs to be kind of looked at. You don't look at that about what -- what role is it playing here? We don't have any of that here. That has not been shown and -- and it will never be able to be shown, frankly.

What we have again, is we look to Hoechst Celanese for good guidance about well, how do you kind of show that connection there? And I think that their -- their analysis is well worth reading again and again and again because that really does control how we do this. And I -- and I think when they look at it, where does Hoechst Celanese come from, you know, what's -- what's the

background? How do we get there? Well, we do start with Supreme Court decisions. We described a long line of BOE decisions. I am, I only gave you a few of them there when with 20th Century Fox was talking about them. There was about seven or eight listed all with the same phraseology about integrally related to the unitary business operations.

So, I -- I think one of the thing is you cannot ignore the Supreme Court rulings. Those are all very relevant here 'cause they all dealt with how do you treat dividends or sales of stock? And while they didn't use business income in each of them, they used apportionable income. No difference. Hoechst Celanese relies on those cases. BOE decisions relies on those cases. Those cases are well worth reading again because frankly, the fact that the Court found non-business treatment, non-apportionable treatment in ASARCO, given the ownership interest, given the intercompany transactions the level, those are staggering numbers. I mean, we're talking about $50 million in 19 -- what year did I get again? -- '68 to '70. That -- that's not peanuts, and yet, there's still enough there, according to the Court, to get you over the hump of being apportionable income.

And -- and the Department of Revenue in Idaho, you know, went for a very broad test, you know, corporate

purpose talking about. And the Court was having none of that. They said that becomes arbitrary if you really -- really push it like that. And I think that, you know, while they use the definition of unitary business, well see, there's difference. It's not business income. That's -- that I think you got to read pretty carefully. Because when you're looking at these cases, that one and then Woolworth right after it, you know, it's the same term. It's months later.

You know, the Court -- the Court basically in both cases said, you know, the fact that you're getting revenue from somebody you invest in, that's not enough guys. And even if it's a related business of some sort, there's got to be something more. And I think that's -- you know, that's what you take from those two cases in particular, frankly. And, you know, I love the phrase that the Court quoted from the Wallace versus Hines case back in 1920, just a few years ago, about adding to the riches. It just doesn't add to the riches. That doesn't make it business income.

So -- so, I -- I think what it is, if you get an economic benefit -- and why wouldn't you get one if you get big dividends. That's an economic benefit. That does not make it business income. I think you go further, and you take further steps into the -- into the Woolworth case

and you get into the profit -- factors of profitability are mentioned there. Now, we're talking about dividends apportionable income. Why are they talking about factors of profitability, which are functional integration, economies of scale, and centralized management?

Well, they get into the thing. It's got to be part of a unitary business operations. That's what -- that's what Hoechst Celanese is selling us. It's got to be integral to our unitary business operation. That's not true. They're big dividends. Don't get me wrong. But the fact of the matter is, did we get any benefits, any special advantages, anything that you can point to that's akin to Standard Oil, Hoechst Celanese, American Biltrite, you know, any of those cases there that -- those are really good examples. CTS Keen, the case that -- that FTB loves. I think there there's a real connection between the licensing agreement there and the purchase of the shares of stock. It is that connection there. It is that operational connection which is missing in this case.

When you get to Allied Signal, Allied Signal is -- is really quite good because again, it's very relevant to what Mr. Whitacre said, frankly. You know, Mr. Whitacre, you know, grew the company tremendously through acquisitions all over the place like that, but they were all investments. They're all investments. Just

you can't take Mr. Whitacre's statements much further than yes, he grew the company. They got large dividends. They ultimately sold for a huge gain in 2014, you know, this last stock of America Móvil.

But the fact of the matter is, the fact that you're in a buying spree, if you will, or you're in acquisition to vestiture policy. That -- that's what Allied Signal says. Whoa, whoa, slow down here. It's got to be -- it doesn't turn a -- an investment function or a passive investment into something that becomes now operational. And I think that's really, really critical here. The investment function is, I think, the best way to describe what we have here in this case.

They own -- they own these shares of stock through a few iterations from 1990 to 2014. So, 24 years. As indicated, there's quite a bit of revenue that they got during that time. They had, you know, operations in Mexico and, you know, down there with these companies. They had interactions with these companies, the three of them. But what they didn't have was that extra little bit. That extra little bit that makes it the integral relationship. And that's part that's just missing here.

And I think the -- the various cases that we've cited I -- I think are all well worth reading again. I've been doing this a long time, and it's always good to go

back and read some of the stuff. And I think that this 20th Century Fox case struck me as one I had even forgot even existed a long time ago. And I read that thing, and I said wow, this -- this thing really kind of nails it a bit; A 100 percent owned entity. The dividends from that, they're not business income. One-hundred percent owned. Are you kidding? Woolworth, three of them, 100 percent owned. Kidding?

So, I think that the fact of the matter is, you got to look at all of the stuff. You got to look at the functional integration. Is it here or not? I believe that we've proven through documents and through testimony that no, there's no functional integration here of any significance. Same thing with centralized management. With Mr. Helú in charge, believe me. And I've heard it from people that worked with him through AT&T and talked about it saying there was no doubt who was in charge. Yeah, you can invest in my company, but it's my company, like that. This is the thing here is this is missing. And no economies of scale of course here. So, we don't have any of those things that are really linking together the shares of stock with the unitary business operation.

And I think that what's -- what's most telling to me, it was the fact that we really enjoyed seeing way back when was that, well, what happened to these investments?

You know, we got hired to handle 2007 and '08. So, okay. So what? Do we still own them? No, got rid of them. Got rid of them when? Got rid of them when? Well, 2014. And you know, there were other iterations with Telmex merging into America Móvil. Telmex Internacional disappeared as well. We had -- we had contracts. We had agreements with America Móvil and Telmex, and we talked about them the Framework Agreement, the various other agreements. Those were all arm's length agreements. They were similar agreements we had with unrelated parties.

We had -- we had a structure about if -- if you wanted to get price breaks, you know, the idea, they -- they didn't get price breaks because they owned stock in those two companies like that. And I -- I think that, you know, the declarations that I read to you this -- this morning here from Mr. Moreira, Mr. Xu, and Mr. Taylor, well worth reading. Those folks were there on the ground, and they -- they kind of give you a little bit of, you know, of how do they do the pricing? The pricing was pretty much about as arm's length as you want to hear about it. My gosh, it was the same with the non -- non-owned entities, non -- non-investees and stuff like that is with others.

So, when you get to 2014, all of a sudden we still have agreements with America Móvil. So, did

ownership of the stock with America Móvil entitle us to be participating in these various agreements and other things like that or any other kinds of breaks, advantages, benefits? The answer is no. I think that's critical. That's why I -- I cited to you yesterday -- was it yesterday or today. I've lost my days. I'm sorry -- about the Bank of America decision, and the whole thing there about the ease of divestment. That was a very well -- good way to put it.

If it's not easy to divest the company and you still maintain the commercial relationship, if you will, then what did the stock do? Did the stock do anything other than have an investment function again? And I think frankly, that -- that, along with all the other stuff that we've -- we've provided -- and I'm not going to repeat stuff, and I know you don't believe me probably, but I'm not gonna go through everything else here. But I do think the fact -- the fact of the matter is we've got a situation here where non-business treatment cries out. This was the way these should be treated here. These were investments. That's how they were held. That's how they were reported, 10-K, everything else here.

What's missing is that linkage, that integral relationship, the organic unity, the interwoven, the inseparable, the indivisible. That's missing here between

the stock AT&T held in these entities and their unitary -- its unitary business. I -- I request that the panel conclude that this was non-business income for the dividends they received.

Thank you.

JUDGE HOSEY: Thank you. We will move to the Franchise Tax Board foreclosing statements if any.

MS. HUANG: [INAUDIBLE]

JUDGE HOSEY: Oh, are you --

MR. VESELY: We've -- we've got a few others.

JUDGE HOSEY: Oh, I'm sorry.

MR. VESELY: You had to know that by now.

JUDGE HOSEY: Go ahead and continue, although we are kind of reaching the half-hour mark now just to --

MR. VESELY: Well, these others won't take so long. All right. We're not --

You're not going to talk about that one?

MS. HUANG: In the interest of time, we're not gonna go through every one and just submit on what we've already argued. So, I think Mr. Vesely is just gonna -- you know, given that we're running up against 30 minutes.

JUDGE HOSEY: It's okay. You got whatever final points you'd like to make on any of the seven issues.

MR. VESELY: Okay.

JUDGE HOSEY: Go ahead.

MR. VESELY: Okay. Yeah, we're -- we're gonna not be labor these next few, to say the least.

The enterprise zone sales and use tax credit, we've talked about that a lot today. You know, our view is that the -- the relevant statutes in -- in that enterprise zone act there, they are not completely clear. Listening to Mr. Riley, you know, discuss what the statutes are, et cetera, that's all well and good, and I don't -- you know, I have all the respect in the world for his views on stuff, but I do think that think is -- these statutes are not clear to support what he's saying, frankly. I think that the -- there's ambiguity there.

And so that I think that when you look at those things yes, credits are generally, you know, a narrow construction. You're not going to get them over very easily, et cetera. You got -- you got to sustain your proof, all these things. We understand that. But there are a few things that I just -- I don't think I ever got a very straight answer to be candid with you. Franchise Tax Board makes a -- makes a comment about that bill, AB 1186, which I'm still not too sure why it's not relevant for your consideration. I mean, that -- that bill was in I think 2007, as I recall, and it initially proposed to add clarifying language to the governing statutory provision to explicitly state quote, "The total cost of qualified

property for purpose of claiming this credit shall not exceed $20 million per enterprise zone," unquote.

That's what AB 1186 initially said. Franchise Tax Board, whatever analysis they made -- and I don't know what exactly what it was, but they did say the following, and they have not said they didn't say this. This bill -- quote, "This bill would make non-substantive changes to the enterprise zone sales and use tax credit in the revenue taxation code. This bill would not impact the Department's programs in operations or state income tax revenue." They said it, you know. The fact that the bill changes and anything else, the fact of the matter is, they said it. And my view is you got -- you got an ambiguous situation then if we've got. It's not quite as clear as Mr. Rile was saying in my view. So, I -- I think that's -- that -- that particular provision, that present issue frankly, I'm hard pressed to see why you wouldn't look it at it as a zone-by-zone basis, frankly.

Go to the last -- next one very quickly is the -- the royalties issue with the partnership sales factor. Again, our argument is very straightforward. The Regulation 25137-1(f)(3)(B), as it read during 2007 and '08, said that notwithstanding any intercompany transactions -- intercompany eliminations -- excuse me, described in subparagraph (a) above, "Sales made to

non-partners shall be included in the denominator of the taxpayer's sales factor in an amount equal to such taxpayer's interest in the partnership," unquote.

That was in effect during our years. It was in effect many years before. FTB has said well, that was wrong, and it should have been changed; and it ultimately did get changed. It got changed in 2018 prospectively for 2019 to basically remove that language from -- from the regulation. But we're looking at the regulation as it read during our years here. And I -- I don't think that it's really appropriate that FTB can disavow their own regulation. I think that's -- they're the ones that promulgated it, and frankly, I think that the fact there's changes later on, that's fine. It doesn't apply to these years, frankly.

The rabbi trust income we've, already I think, argued that one to death. I have nothing more to say on that one.

The accuracy-related penalty issue, I think -- and we'll talk to Counsel for FTB about the mechanics of how we're gonna deal with the numbers here afterwards, if that's possible. But our view is -- is we're left really principally with the enterprise zone sales and use tax credit, and I think that if we haven't provided substantial authority, then we also -- we do satisfy the

exceptions either under the adequate disclosure, reasonable basis, reasonable cause, you know, all the other things that I've mentioned earlier today.

And I think we really start with the whole thing, do we have a substantial understatement to begin with, and that's kind of something we have to workout with the FTB, I think. And I think from a standpoint that penalty should not arise here for the sales and use tax credit.

So, I -- I have nothing more. Okay. Thank you.

JUDGE HOSEY: Great. Thank you.

Now, I'll move to the Franchise Tax Board for your closing statements.

MS. MCELHATTON: Thank you.

JUDGE HOSEY: Thank you.

CLOSING STATEMENT

MS. MCELHATTON: First to discuss Issue 1, the test for unity is not full integration between AT&T and BellSouth. FTB is not arguing, and is not required to argue, that full integration occurred three days after the merger on January 1st, 2007, which is impossible. The date marks the starting point of unitary ties in a relationship between AT&T and BellSouth due to the merger that only grew stronger throughout the year. The test to be applied is whether AT&T contributed to BellSouth during

2007 and whether BellSouth depended on AT&T.

AT&T and BellSouth became unitary on January 1st, 2007, or, at the very least, during 2007 and not 2008, based on sufficient unitary ties throughout the 2007 year, which we have detailed in our briefing and in oral argument yesterday and today. And this satisfies the contribution or dependency test. The facts presented and relied upon by FTB are based on contemporaneous evidence made public by the taxpayer. FTB's reliance on these facts is not disingenuous, but rightfully based on evidence that should be given great weight as the evidence came from Appellant.

Appellant has focused its arguments on what it claims it was unable to do, which is to plan for integration of AT&T and BellSouth, despite an over 400-page merger Playbook setting out in detail how the integration would take place and also the commitment of significant resources, executives, many people working for 10 months on this integration plan. While it is possible that some activities detailed in that document did not occur as exactly as described there, the fact remains that AT&T executives reported that the integration occurred on time and was even ahead of schedule for many of the projects. Slight differences from the merger Playbook are not relevant when looking at the overwhelming amount of

premerger integration planning.

A vague statement that some of the items in the merger Playbook may not have occurred is not sufficient to overcome the level of planning that started 10 months prior to the merger. In addition, pointing to some of the projects that wound up in 2008 is not sufficient to overcome that unity existed during 2007. At the time of the merger, AT&T immediately announced that the three companies are now one company. AT&T bundled services from all three companies and touted its expanded reach now that it had the nine state region previously operated by BellSouth. BellSouth was not operating independent from AT&T during 2007. Rather, AT&T contributed to the BellSouth operation in the many ways detailed yesterday. And BellSouth depended upon AT&T, as BellSouth was being operated from within AT&T Southeast with executives appointed by AT&T.

Why would the BellSouth CEO and chairman positions be left vacant at the time of the merger if BellSouth was an independent operation? Why would BellSouth allow its services to be bundled with AT&T services and offered to their combined customers if BellSouth was independent of AT&T during 2007? Why would there would be a shared email, shared global address book between the three companies during 2007 if BellSouth was

independent of AT&T? And why would the AT&T CEO announce that the three companies were now one company?

The answer is that BellSouth was not operating independently from AT&T during 2007. BellSouth's financial and workforce data was input into the AT&T data system immediately after the merger. Corporate departments were immediately merged. Thousands of personnel were laid off, and then other personnel were added to handle the larger operation. In addition, AT&T and BellSouth were operating both the Yellow Pages and Cingular together well before 2007. The fact that two entities were already operating a business together is an element to be considered under Appeal of Dr. Pepper.

The date that unity is found is the date when sufficient unitary ties existed. As found in Tenneco West, the integration of executive forces is an element of exceeding importance. It is top-level management which was -- is credited with the effects of the corporate enterprises. The major policy matters are what count in our estimation of integration.

And now I'll move onto Issue 2. The prior appeal for 2000 -- this is the business non-business with the Mexican companies issue, just to clarify. The prior appeal for 2001 and 2002 was decided based on facts that were available at that time. Those facts may not have

been at the level of detail that we have for this cycle. For Issue 2, whether dividends from the Mexican companies were business income to AT&T, Respondent has shared ample facts of how Mexican companies were operational assets rather than passive investments. An example of the operational nature of these assets is the reseller agreement whereby Tracfone, which was owned by America Móvil, was selling AT&T cellular minutes to its own Tracfone customers, who were then counted as AT&T customers; and AT&T sent out the bills.

Another example is the master services agreement where AT&T had employees performing very detailed tasks on the Mexican company premises. Those details have been included in our briefing. In addition, AT&T was basically teaching the Mexican companies how to operate a modern telecommunication system with AT&T personnel at the Mexican company facilities to carry out the different differences agreements. This involves system upgrades, requiring the ordering, the testing, the installing of equipment by AT&T personnel in Mexico at the Mexican company facilities, monitoring through meetings and task plans. As explained by the State Board of Equalization in Appeal of CTS Keen, it simply is not necessary that CTS have acquired control of the Mexican companies before income from the stock can be considered to be business

income.

Under Appeal of Occidental Petroleum, if the Mexican company shares were integrally related to the AT&T unitary business activities, then the dividend income paid by the Mexican companies is business income to AT&T. This is not complicated. Non-business income is only found if the intangible is unrelated to those activities. One cannot say that the Mexican company operations were unrelated to the AT&T telecommunications business. As explained in Appeal of Standard Oil, AT&T stock holdings in the Mexican companies cannot be viewed as extraneous investments separate and apart from AT&T's unitary business operations.

Standard Oil sets out that the concept of business income generally concerns the differentiation between truly passive investment income and income which is integrally related to the taxpayer's unitary business activities. We have shown that the Mexican company's stock was not held as a passive investment. We also know from Allied Signal that the Mexican companies that paid the dividends in AT&T are not required to be engaged in a unitary business before the dividends can be found to be the business income. What is required has been set forth in Hoechst Celanese, which is to meet the functional test from Revenue & Taxation Code section 25120(b).

AT&T must have obtained some interest in and control over its shares in the Mexican companies to generate business income, which it did through the interconnect agreements, master service agreements, the reseller agreements, and more. For management, AT&T must have had the power to direct the use of the Mexican company shares, which it did by participating in the executive committees and the board of directors. And for disposition, AT&T must have had the power to transfer control of the Mexican company shares in some manner, which it had as it could sell the shares at any time.

AT&T's goal of expanding its telecommunications market into Mexico was accomplished by becoming a minority shareholder. This is under appeal of CTS Keen. Agreements that are at arm's length can still be operational agreements. Appellant has cited no authority which states that there can be no operational relationship where agreements are at arm's length. There is no requirement to follow a factors of profitability test.

The test that Appellant wants to apply here functional integration, economies of sale, and centralized management, these are unity tests. The Asarco case was decided on the basis of unity. The test applied in Asarco was a unit test. We recommend reading Allied Signal to understand the difference between a unity test and a

business income test. This is a business income issue, and the functional test has been met.

Now moving onto Issue 3, unity of AT&T and Cingular. We've explained why the issue is unity between AT&T and Cingular. The main reason being that Cingular was added to the AT&T combined report, along with BellSouth. So, if Appellant seeks to undue that adjustment, we must analyze whether AT&T and Cingular were unitary. This is not a new position, but rather a clarification of an issue that was raised at protest. Appellant had the full briefing cycle to respond to the clarified issue and thus, there is no shifting of burden of proof. As has been explained, AT&T became the 100 percent owner of Cingular on the day of the merger. During 2007, AT&T announced many executive appointments, such as the president and CEO for AT&T Wireless, which is what Cingular was referred to after the merger; and explained that Cingular would immediately be folded into AT&T operations.

If Cingular was operating independent of AT&T during 2007, and then why would AT&T be announcing the executive appointments for Cingular? And for that matter, why would Cingular be operating under the name AT&T Wireless during 2007? The reason is that Cingular was being folded into the AT&T operation from day one,

including a combination of corporate departments, combination of financial and workforce data, the shared email, global address book, bundled offerings to the customers for all three companies, some which occurred starting in 2006, and then brand new plans that were announced in 2007; co-branding and rebranding, so that part way through 2007, Cingular was not even being used in AT&T press releases anymore, consolidation of intellectual property assets into the AT&T database, intercompany financing with AT&T providing funding to BellSouth on a daily basis.

Cingular Wireless services included in the AT&T unified messaging products suite for medium businesses, and Cingular wireless services being offered as a part of the AT&T unity plan providing a single bill for wireless and wireline services, plus more consolidation activities. From these many joint operations, it is apparent that AT&T was contributing to Cingular, and Cingular was depending on AT&T for major policy decisions and incorporation into the AT&T telecommunications business.

For Issue 4, the enterprise zone sales and use tax credit issue, Respondent properly applied the statute's $20 million limit to Appellant's enterprise zone sales and use tax credit and recommends that this panel sustain FTB's position.

For Issue 5, this is the intercompany royalties issue. As was explained in our oral argument and in our briefing, Appellant is not arguing that it should be required to include these intercompany royalties in its taxable income base. I'm not hearing that argument. It would not argue that because these royalties are clearly intercompany, and it doesn't want to the addition to its income. However, it does not correlate that these royalties would not included in the sales factor when the income is not included in taxable income because it's been eliminated. The unitary principals discussed in our argument in the Chase Brass case, require a finding that royalties paid by combined reporting group members to other members of the same combined reporting group do not give rise to income. And therefore, since there has been no economic change in the combined reporting group, there's no representation in the sales factor.

And then for Issue 6, this is the rabbi trust. Appellant has failed to exhaust its administrative remedies by not responding to IDR requests early in the process. FTB made its decision that the income from the rabbi trust was business income based on the facts that we had, some general research on what a rabbi trust is, and application of the precedential Hoechst Celanese case, which applies here and is directly on point. Respondent

request that its position that the income paid by the rabbi trust to Appellant be found to be business income and be sustained since the rabbi trust was created to attract and retain employees, which is entirely a business purpose.

And then finally, Issue 7 for the accuracy-related penalty issue. Because Appellant has not established a valid defense to the ARP, Appellant has failed to meet its burden of proof to show that the ARP should be abated. Therefore, the penalty be -- should be sustained.

Thank you.

JUDGE HOSEY: Thank you. I'm gonna go to the panel for final questions before we'll have any final statements from the Appellant, as this is your appeal.

Moving to Judge Lambert, any final questions for the parties?

JUDGE LAMBERT: No. No questions. Thanks.

JUDGE HOSEY: Judge Gast, any final questions for the parties?

JUDGE GAST: No questions. Thank you for your presentations these last two days.

JUDGE HOSEY: I don't have any as well, but I will go to Appellants for any final statements before we close for the day.

MS. HUANG: Thank you, Judge Hosey. I promise to be short. I know it's just two days.

ADDITIONAL CLOSING STATEMENT

MS. HUANG: And let me apologize first if some of my points sound representative because I'm just trying to address what Respondent just said. I have five points.

One, Respondent said that they are not arguing full integration on January 1st, 2007. There's just asking that it is the starting point for integration. May I remind the panel of the appeal of the Signal Companies. Again, like I discussed earlier today, they acquired majority interest in UOP on May 1st, 1975, and the taxpayer said they were unitary as of that date; basically, instantly unitary. FTB said no. BOE said no. Because they were not instantly unitary even though over the following months, they had enough integrating ties to indicate operational integration.

The FTB said they were 1/1/76 as unitary date. The taxpayer argued no, at the very least/ we were integrated by October 1st -- you know, fourth quarter of 1975. Because the facts between first quarter 19 -- last quarter of 1975 and January 1, 1976, there were no real differences. So, FTB is saying oh, that's not what we're arguing. We're saying as long as that they're starting to

integrate, that's enough for instant -- before instant unity. That's not the law.

We were talking about two multibillion-dollar companies, and -- and the FTB's argument here is as long as there's a thought of integration and you start to integrate, then you are instantly unitary. Imagine the FTB -- if the taxpayer made that argument. Would FTB accept that? You have two companies coming together saying you know what, we plan to integrate. I mean, why would two companies come together? Of course, to get the synergies of the company, right. They were gonna -- we're gonna integrate. It might take us 10 years, but you know what, we plan to integrate. We're gonna start integration and therefore, we're instant -- you know unitary. That is not the law. There's no basis for that argument.

And not only that, in the Signal Companies it says here, while the potential existed as of that time -- which is time of the acquisition, because -- while the potential exist -- potential integration existed as of that time simply because Appellant's major ownership of UOP, the realization of that potential clearly developed over the months following acquisition. And therefore, the BOE and the FTB said not instant unitary in the Signal Companies.

Okay. Moving on to the next point. The FTB also

argued that because they operated a business together, you know, that was also a sign of basically, that they could be integrating on day one, and they point to Dr. Pepper. Again, I would like to point out once again, Dr. Pepper was vertically integrated. They were vertically integrated, the two companies were. Here, we -- there's no law saying if you have a joint venture with another publicly traded company and you somehow merge the two publicly traded companies, they are instantly unitary because you have a joint venture; a joint venture that ran independently. Cingular ran on its own. Okay.

So, now point three. I think that the Respondent also argued or tried as -- as a factor, a unitary -- a unitary tie-in factor that because BellSouth had an empty CEO seat and therefore, you know, that went against its independence despite all the facts, despite Ms. Biry's testimony. I -- I would like to remind everybody here that the law does support divisions within a company to be non-unitary. So, I'm not quite sure why having an empty seat in a combined publicly you traded company, where you can only have one CEO, is -- is -- is an integrating factor.

And moving to the fourth point, Respondent argue that their evidence should be given great weight. I -- I strongly disagree. As you have heard, despite Ms. Biry's

testimony, despite Exhibit 47, Respondent continues to argue the facts they are contrary to what we have provided. So, we would say the -- the weight given to their facts are not relevant and should be -- I shouldn't say not relevant. The weight given to them should be very little.

As also, the other thing that they continue to ignore is the Playbook. The Playbook -- sure, time was spent on the Playbook. We do not deny that. But it is not an integration plan because it was thrown out, basically, as soon as shown to the BellSouth people. Ms. Biry testified to it. She went through it. She lifted. She worked with the BellSouth folks. She argued with the BellSouth folks, and the BellSouth, you know, teams came up with their own operational plans. The Playbook was no longer relevant. It wasn't just oh, only a few items were weren't followed. The Playbook was essentially thrown out. That's what Ms. Biry testified to. Somebody who lived this for two whole years before she moved onto another role in 2009.

And the last point I'd like to make is Respondent keeps insisting that things happened before two -- before merger date; thus, things happened in 2006. I -- I don't know how many times I need to emphasize that the law prohibited -- prohibited -- absolutely prohibited any kind

of integrating plans, discussions, sharing of information. So nothing could have happened premerger because it was prohibited by law.

Thank you. I don't know. I'll turn to Mr. Vesely.

MR. VESELY: No.

MS. HUANG: Thank you very much.

JUDGE HOSEY: Thank you.

I think we're ready to conclude the hearing if there's no other comments from the parties. Seeing none, the evidence has been admitted into the record, and we have the arguments and your briefs, as well as the oral arguments and testimony presented this week. So, we now have a complete record from which to base our decision.

However, we're not closing the record at this time as we have this severed alternative apportionment issue remaining.

So, the panel will meet and deliberate to decide the issues discussed in this appeal in a written opinion, and then a separate briefing period hearing an opinion will be set after the issuance of this opinion. Any questions on that before I move on?

MS. MCELHATTON: We would need a slight deferral time because we have our own internal process, and our committee -- our internal committee needs to decide. But

Appellant has not provided anything yet. So, they need to provide their arguments, facts, and law, and then we have someone who works it up and does a recommendation; and then our committee hears it and makes a decision. So, this is how we handle these, and so we would need a few months to be able to do that.

JUDGE HOSEY: We can work with the parties to have the processing figured out. We can reach out to you, and if -- you can let us know the timing that works for both of you.

If there are no other questions or concerns that I can address, we will be concluding today's hearing, and we are now off the record.

(Proceedings concluded at 1:35 p.m.)

HEARING REPORTER'S CERTIFICATE

I, Ernalyn M. Alonzo, Hearing Reporter in and for the State of California, do hereby certify:

That the foregoing transcript of proceedings was taken before me at the time and place set forth, that the testimony and proceedings were reported stenographically by me and later transcribed by computer-aided transcription under my direction and supervision, that the foregoing is a true record of the testimony and proceedings taken at that time.

I further certify that I am in no way interested in the outcome of said action.

I have hereunto subscribed my name this 23rd day of October, 2026.

_____
ERNALYN M. ALONZO
HEARING REPORTER